

Exhibit Y

Karl A. Frieden, Fredrick J. Nicely, Priya D. Nair, "*Down the Rabbit Hole: Sales Taxation of Digital Business Products*", July 18, 2022

Down the Rabbit Hole: Sales Taxation of Digital Business Inputs

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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.

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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

¹See 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.

²Karl 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).

(SaaS, also referred to as remotely accessed software), digital information services, and data processing).³

During the early years of digital commerce, several significant issues emerged regarding the sales taxation of digital products, including (1) which digital goods and services should be included in (or excluded from) the sales tax base; (2) whether states have jurisdictional nexus over remote sellers; (3) how to define and categorize digital products for sales tax purposes; and (4) how to source sales of digital products.⁴ All these issues have been widely discussed in tax policy circles, closely scrutinized in legislative or judicial forums, and extensively covered in the tax news media.

One central problem, however, regarding the sales taxation of digital commerce is 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. This article focuses on the absence of sales tax exemptions in most states for purchases of software and digital products by businesses (digital business inputs), and the negative policy implications it creates for the efficiency and effectiveness of state sales tax systems. Currently, only one state (Iowa) grants a broad exemption for digital business inputs; three states allow partial exemptions (Maryland, New Jersey, and Washington); and one state imposes a reduced rate for business

purchases (Connecticut).⁵ All other states that tax some or most digital products fail to exempt digital business inputs. In this regard, the states' approach to expanding the sales tax base to digital products exacerbates the long-standing structural flaw in state sales tax systems — the inefficient cascading of sales tax on both businesses and consumers.

Part 1: Key Issues Regarding the Sales Taxation of Digital Products

Sales Tax Base Expansion

Over the last several decades, states have gradually but inexorably expanded their sales tax bases to include more categories of digital products. This has been particularly evident with products previously sold in tangible form that are now transferred to or accessed by consumers electronically. For example, the number of states that tax “specified digital products” based in part on the Streamlined Sales and Use Tax Agreement — encompassing the transfer of audio, video, and books by digital means — has nearly doubled in the last 15 years.⁶ In 2007, 18 states taxed a category encompassing specified digital products.⁷ In 2022, 35 states taxed specified digital products (see Figure 1).⁸

³There are also important policy considerations regarding goods and services that are purchased over the internet but delivered as tangible products or in-person services. However, these concerns largely center on jurisdiction to tax remote sellers, and generally do not raise the additional issues discussed in this article relating to digital products.

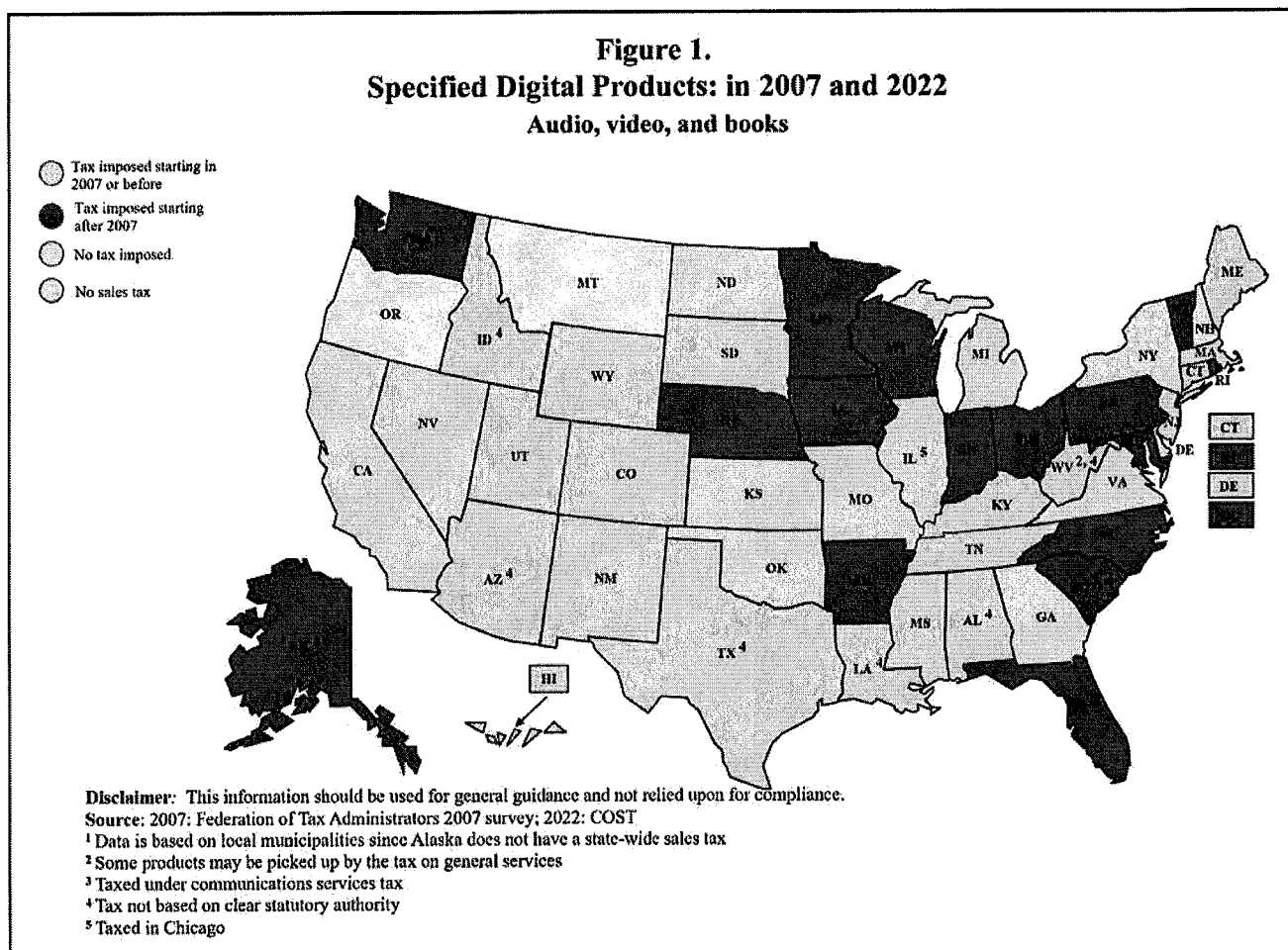
⁴COST does not take a position on the appropriate state or local sales tax rates imposed on digital products, nor on the optimal breadth or narrowness of a sales tax base inclusion of digital products purchased by consumers. However, COST does oppose including in the sales tax base digital products purchased by businesses (e.g., business inputs). (See COST, “Sales Taxation of Business Inputs: Policy Position.”) COST also maintains that if a state imposes sales tax on digital products purchased by consumers, it should do so only by using clear statutory provisions and reasonable and uniform sourcing rules. (See, e.g., COST, “Sourcing Sales and Use Taxes Should be Uniform and Approximate Where Products are Used.”)

⁵While Iowa is noteworthy for its broad business inputs exemption for digital products, the Iowa legislature considered narrowing its exemption during the 2022 session with H.F. 2583.

⁶For the SSUTA definition of specified digital products, see sections 332 and 333 of the SSUTA.

⁷Federation of Tax Administrators, *Sales Taxation of Services, Actual Survey Data — 2007*, at lines 118-120 (rev. Mar. 2010). Of note, it appears that some state tax administrators took aggressive positions that their definition of tangible personal property encompassed these digital products.

⁸Karl A. Frieden, Fredrick J. Nicely, and Priya D. Nair, “The Best and Worst of State Sales Tax Systems: COST Scorecard on Sales Tax Simplification, Uniformity, and Exemption of Business Inputs” (forthcoming Sept. 2022). For simplicity purposes in describing the results of the COST Scorecard in figures 1 through 10, we categorize the District of Columbia and the Alaska municipalities as “states.”



While the digital sales tax base has steadily expanded, the number of digital products included or excluded from sales tax varies widely among states. About three-quarters of the states with sales taxes include software transferred electronically and specified digital products in the sales tax base (see figures 2, 7). By contrast, only about two-fifths of the states with sales taxes include software accessed remotely (SaaS) and digital information services in the sales tax base, and about one-fifth include data processing in the sales tax base (see figures 4, 5, and 6). While there is no consistent pattern, states more frequently impose sales tax on digital products that were previously sold in tangible form (for example, prewritten software, books, movies, and music),

and less frequently on digital goods and services that were not (for example, SaaS and data processing).⁹

⁹ The imposition of sales tax on digital products previously taxed in tangible form does not always translate into equivalent levels of sales tax revenue. The preference of consumers for digital downloads and streaming is based not just on convenience, but also on significant savings in purchasing some of those products, especially music. Revenue from the retail sale of music in the United States peaked at around \$21.5 billion in 1999 (mostly compact disc sales with some cassette sales); see Kristina Osterman, "Music Streaming Services vs. Buying Tangible Music," *The Current*, Dec. 27, 2019. Streaming of music (including MP3 sales) started around 2003 and has grown to account for 83 percent of music purchases in 2020. However, overall retail music revenue in the United States was only \$12.2 billion in 2020, down more than 40 percent from its peak in 1999; see Joshua P. Friedlander, "Year-End 2020 RIAA Revenue Statistics," Recording Industry Association of America. Purchases of consumer books is more of a mixed bag. In 2018 59.2 percent of book revenue was from paperback or hardback sales and 18.6 percent was related to e-books and audio. The remaining percentage was from miscellaneous categories. However, in January 2022 the percentage of revenue from paperback and hardback sales increased to 71.1 percent, while e-books and audio only slightly increased to 19.9 percent of total revenue; see Julia Stoll, "Home Transactional Video Revenue U.S. 2014-2021, by Type," Statista.

Sales taxation of digital products was also the catalyst for the U.S. Congress to use its commerce clause powers to impose restrictions on state taxation of the internet. First with the Internet Tax Freedom Act in 1999, and later with the Permanent Internet Tax Freedom Act (PITFA), Congress imposed limitations on states' ability to tax digital products.¹⁰ PITFA prevents states from imposing sales taxes on internet access and from imposing discriminatory taxes on digital products. For instance, if a state does not tax advertising but seeks to impose a tax on digital advertising, such a tax arguably violates PITFA. That type of tax scheme is being litigated in Maryland.¹¹

Jurisdiction to Tax

Another hotly debated issue relating to the sales taxation of digital products is whether a state has the jurisdiction to require remote sellers without a physical presence in the consumer's state to collect sales or use tax. This issue arose in the pre-digital era with mail-order sales by remote sellers. In two U.S. Supreme Court cases, *National Bellas Hess v. Illinois*, 386 U.S. 753 (1967), and *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992), the Court ruled that requiring remote sellers to collect sales and use tax on mail-order sales in a state where the seller had no physical presence was constitutionally impermissible because of violations of the due process clause (only in *National Bellas Hess*) and the commerce clause (in both cases). The *Quill* rationale was grounded on the burdens on interstate commerce arising from the lack of uniformity among the 45 states (and the District of Columbia) and the thousands of local jurisdictions with disparate sales and use tax bases and administrative rules.¹²

¹⁰ PITFA, 47 U.S.C. section 151.

¹¹ *Chamber of Commerce of the United States v. Franchot*, Case 1:21-cv-00410-DKC, Civ. No. 21-cv-410 (D. Md. Feb. 18, 2021); *Comcast of California/Maryland/Pennsylvania/Virginia/West Virginia LLC v. Comptroller of Maryland*, C-02-CV-21-000509 (Cir. Ct. Ann Arundel Cty. 2021).

¹² The Supreme Court limited its decision in *Quill* to the commerce clause, which Congress could address with its plenary legislative authority. If the Court had ruled that imposing state sales taxes on sellers with no physical presence violates the due process clause, Congress would have greater difficulty addressing the issue. Some members of Congress post-*Wayfair* in 2018 pursued legislation in this area, especially those representing states without a sales tax. See, e.g., Online Sales Tax Simplicity and Small Business Relief Act of 2018 (S.B. 3275); Protecting Small Business from Burdensome Compliance Cost Act (H.R. 6724); and No Retroactive Online Taxation Act of 2018 (H.R. 7184).

The sales taxation of digital products, especially with sellers having no physical presence in the taxing state, was dramatically changed by the Supreme Court's landmark decision in *South Dakota v. Wayfair*, 138 S. Ct. 2080 (2018). That decision modified the substantial nexus prong derived from the Court's decision in *Complete Auto*¹³ to allow states to tax based on a "virtual or economic" basis. As a result, the states' obstacles to imposing a sales tax collection responsibility on remote sellers of digital products almost immediately disappeared. The *Wayfair* decision not only overturned the long-standing jurisdictional rules for sales taxes, but simultaneously expanded digital sales tax revenues by imposing a new collection responsibility on hundreds of thousands of remote sellers. While *Wayfair* helped open doors to allow states to require sellers to collect tax on the sale of digital products, complex issues with defining and sourcing those sales, addressed below, still present significant problems.

Tax Base Definitions and Sourcing

The sales taxation of digital commerce has also engendered significant policy considerations regarding the categorization and sourcing of digital products. The Streamlined Sales and Use Tax Project, initiated in March 2000, was one of the first and most expansive efforts to address some of the administrative complexities of imposing a sales tax on digital products.

The streamlined sales tax states began to look at the taxation of some digital products soon after their agreement officially took effect in 2005. The SSUTA does not take a position on the inclusion or exclusion of digital products from the state sales tax base. Rather, it provides uniform definitions and sourcing rules for a state to adopt should it decide to tax digital products.

In 2007 the SSUTA was amended to address specified digital products, primarily digital books, audio, and video and a catchall for products "transferred electronically."¹⁴ The

¹³ *Complete Auto Transit Inc. v. Brady*, 430 U.S. 274 (1977). The Court in *Wayfair* did not address the constitutionality of South Dakota's law under the commerce clause for the three other prongs (fairly apportioned, discriminatory, or fairly related to services) or the due process clause. The case was remanded, and later settled, without those issues being addressed.

¹⁴ See sections 332 and 333 of the SSUTA, *supra* note 6.

agreement mandates that if a streamlined state includes these digital products in its sales tax base, it must adopt the SSUTA's uniform language and not include digital products under the state's definition of tangible personal property.¹⁵

The SSUTA also has sourcing provisions that apply to the retail sales of products, including digital products. Section 310(A)(1)-(A)(5) of the agreement establishes a five-step hierarchy for the sourcing of sales that streamlined states must follow to remain in substantial compliance.¹⁶ The sourcing rules in the SSUTA continue to evolve and focus on new issues, recently addressing products not requiring a delivery address for a customer to purchase them. Both the states and some sellers have concerns over sellers trying to avoid obtaining purchaser address information that approximates a purchaser's consumption location and thereby avoid correctly imposing the sales tax on digital products.¹⁷ The SSUTA states and the business community are mutually trying to address this issue to reduce the chances that foreign sellers or sellers located in a state not imposing a tax on digital products can avoid collecting tax. Limiting liability relief for sourcing with no customer address information or requiring a purchaser to provide at least a five-digit ZIP code are some options being explored.

Part 2. The Absence of Exemptions for Digital Business Inputs

Over the last quarter-century, the sales taxation of digital commerce has accounted for some of the most complex and compelling state

tax issues. During that span, states grappled with the breadth of the digital sales tax base, the jurisdiction to tax remote sellers, definitional issues regarding categorizing digital products, and the sourcing of sales. Much less noticed, let alone addressed, was the disturbing trend of states imposing the sales tax on not just consumer purchases of digital products, but on business inputs as well.

As part of the 2022 update of the Council On State Taxation's Scorecard of State Sales Tax Systems,¹⁸ we analyzed sales tax exemptions for business inputs in each state that imposed a sales tax on six software and digital product categories: (1) prewritten (canned) software, including by electronic delivery; (2) custom software; (3) digital software accessed remotely (SaaS); (4) digital information services; (5) data processing services; and (6) specified digital products. In total, only three states (Iowa, New Jersey, and Washington) allow any kind of exemption for business purchases of software or digital products; and one state (Connecticut) imposes a reduced rate for business purchases. Only Iowa has an exemption that covers most taxable digital commerce.

Prewritten Software

Prewritten software is taxed by every state that imposes a sales tax. Thirty-six states impose a sales tax on prewritten software both in tangible form and delivered electronically. Eleven states impose a sales tax on prewritten software sold in tangible form, but not if the same software is delivered electronically. Of these states, Iowa exempts business purchases of prewritten software, New Jersey exempts business purchases of prewritten software delivered electronically, and Connecticut applies a reduced rate of 1 percent to business purchases of prewritten software delivered electronically (see Figure 2).¹⁹

¹⁵While the SSUTA addresses many digital products, the taxation of SaaS and other computer services is not fully addressed in section 332. The SSUTA also has limitations on state taxation of digital products on a nonpermanent basis or based on continued payment if a state does not have a statutory provision to tax these products on that basis.

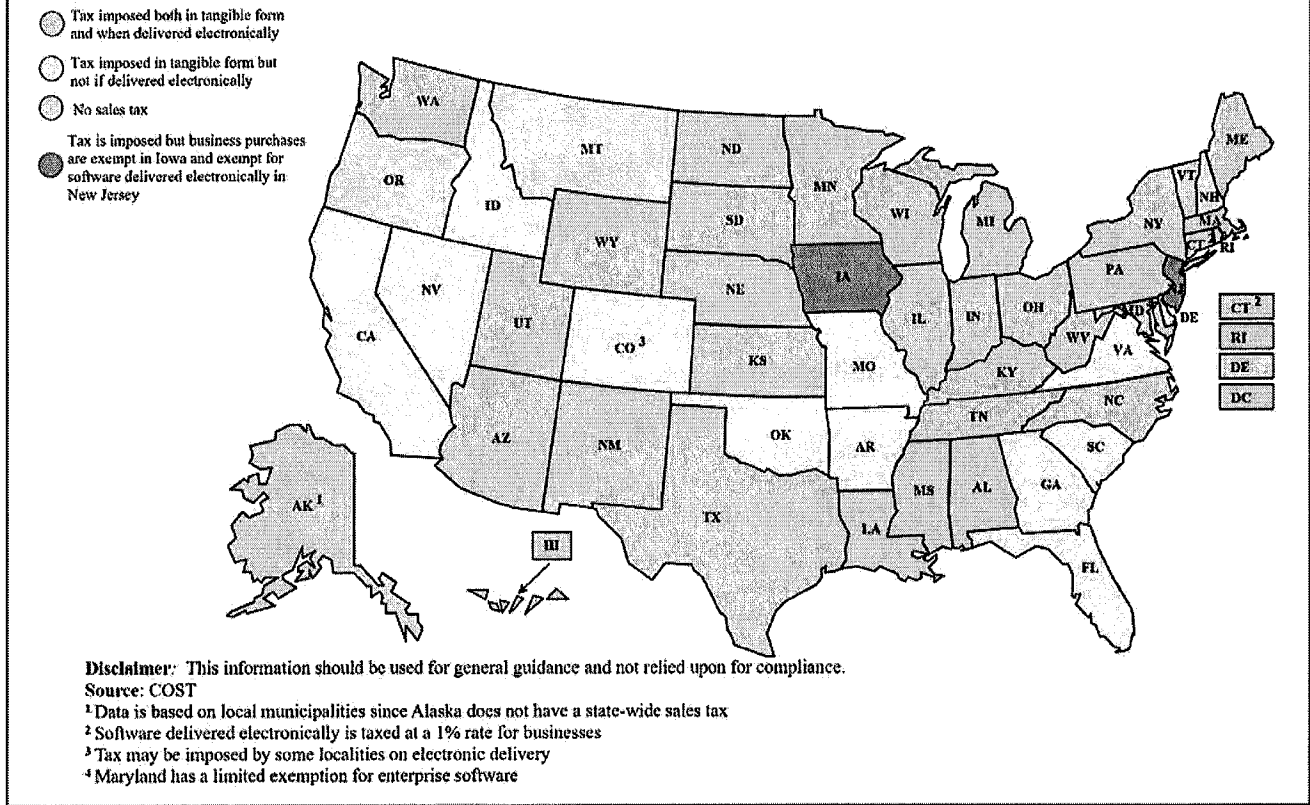
¹⁶The SSUTA has two sourcing provisions. The first, section 310, provides a hierarchy for sourcing sales to a state: (1) over-the-counter location, (2) delivery address, (3) home/business address, (4) billing address, and (5) default to seller's location. The second is for SSUTA states with local taxes (section 305), which provides liability relief if a seller or certified service provider uses state-provided database information to determine local tax rates by street address and five- and nine-digit ZIP codes.

¹⁷While many sellers capture purchaser address and payment information to conveniently (and quickly) make future sales to purchasers and for marketing purposes, the use of gift certificates, cryptocurrency, or other payment methods may not require a purchaser to provide address information. Under the SSUTA, this can lead to sales sourced to the seller's location (section 310(A)(5)) rather than approximating the purchaser's location.

¹⁸Frieden, Nicely, and Nair, *supra* note 8. All data used in figures 1 through 10 in this article, except as noted on figures 1 and 8, are derived from COST staff research and surveys of state departments of revenue and practitioners in each state.

¹⁹N.J. Rev. Stat. section 54:32B-8.56; New Jersey Division of Taxation, "Taxability of Software," TB-51(R) (July 5, 2011).

**Figure 2.
Prewritten Software**



Custom Software

Unlike prewritten software, the majority of states do not impose sales tax on custom software. Only 15 states include custom software in the sales tax base. Of these states, Iowa exempts the business purchase of custom software, and Connecticut applies a reduced rate of 1 percent (see Figure 3).

Software Accessed Remotely (SaaS)

The taxation of software accessed remotely, also known as SaaS, reflects a more even split among the states than for the prewritten and custom software categories. Twenty-two states impose a sales tax on SaaS and two states have no clear position on whether a tax is imposed. Of these states, only Iowa provides an exemption for business purchases, and

Connecticut applies a reduced rate of 1 percent for business purchases (see Figure 4). Conversely, Ohio, for SaaS, digital information services, and data processing, imposes the tax on such digital products *only if* they are purchased for business use.²⁰

Digital Information Services

The majority of states do not impose a sales tax on digital information services. Of the 19 states that do, only Iowa exempts business purchases. Connecticut applies a reduced rate of 1 percent to purchases of digital information services (see Figure 5).

²⁰ See Ohio Rev. Code section 5739.01(B)(3)(e).