

29th ANNUAL

PAUL J. HARTMAN
STATE AND LOCAL TAX FORUM

VANDERBILT UNIVERSITY LAW SCHOOL

Sales Taxation of Digital Goods, Advertising, and Services

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Karey Barton

Nancy Prosser

Chris Wilson

KPMG LLP



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Agenda & Topics

1. Current Status of Sales and Use Taxation of Digital Products
2. Uniformity efforts by the MTC and Streamlined states
3. Legislative hearings and research
4. Regulatory guidance
5. Legislative proposals
6. Maryland's digital advertising tax (DAT)
7. Litigation over Maryland's DAT & otherwise
8. Thoughts about the future

Current Status of Sales and Use Taxation of Digital Products

- Prewritten Software

- Taxable
 - 35 states
- Not Taxable
 - 11 states

- Software as a Service (SaaS)

- Taxable
 - 17 states (one at reduced basis)
 - All 17 states provide guidance
- Not Taxable
 - 20 states
 - 18 states provide guidance
- Unclear
 - Likely Taxable – 2 states with one providing guidance
 - Likely Not Taxable – 5 states with 2 states providing guidance

Current Status of Sales and Use Taxation of Digital Products

- Infrastructure as a Service (IaaS)

- Taxable

- 4 states (one at reduced basis)
 - All 4 states provide guidance

- Not Taxable

- 13 states
 - 1 state except e-storage products
 - All 14 states provide guidance

- Unclear

- Likely Taxable
 - 3 states (one at reduced rate)
 - 1 state if server located in state
 - Likely Not Taxable – 3 states
 - Taxability unclear - 19 states

- Database – Information Services

- Taxable

- 12 states (2 at reduced basis/rate)
 - 11 states provide guidance

- Not Taxable

- 13 states
 - 12 states provide guidance

- Unclear

- Likely Taxable – 3 states with 2 providing guidance
 - Likely Not Taxable – 6 states with 2 states providing guidance
 - Taxability Unclear – 12 states with 1 state providing guidance

Current Status of Sales and Use Taxation of Digital Products

- Digital Books

- Taxable – 29 States
- Not Taxable – 14 states
- Unclear
 - Likely Taxable – 2 states
 - Likely Not Taxable – 1 state

- Audio

- Taxable – 29 states
- Not Taxable – 14 states
- Unclear
 - Likely Taxable – 2 states
 - Likely Not Taxable – 1 state

Current Status of Sales and Use Taxation of Digital Products

- Audio Visual

- Taxable – 28 States
- Not Taxable – 15 states
- Unclear
 - Likely Taxable – 2 states
 - Likely Not Taxable – 1 state

- Streaming Services

- Taxable – 18 states
- Not Taxable – 14 states
- Unclear
 - Likely Taxable – 10 states
 - Likely Not Taxable – 3 states
 - Taxability unclear – 1 state

Lack of Definitions

- Smartphone Apps
 - Taxable – 23 states + DC
 - Taxable w/exceptions – 2 states
 - Not Taxable – 15 states
 - No Guidance – 5 states

Understand and Clearly Define What You Are Selling.

- Proper classification is essential!
 - SaaS vs. Service?
 - Many states apply a “primary purpose” or “true object” test to classify.
 - Very facts and circumstances oriented.
 - Can request a ruling from the Department.
- Form vs. substance
 - Ensure that contract documentation is consistent with what you are selling.
 - i.e., documenting the sale of an online service with a “software license” (or vice versa) creates headaches with auditors, who may tax an otherwise non-taxable transaction based upon the contract form alone!

Definition Adoption is Mixed

- **“Digital Product”**

- Not Defined – 22 states
- Defined – 25 states

- **“Digital Audio Visual Works”**

- Not Defined – 26 states
- Defined – 21 states

- **“Digital Product”**

- Not Defined – 26 states
- Defined – 21 states

- **“Digital Audio Visual Works”**

- Not Defined – 24 states
- Defined – 23 states

Uniformity Efforts - MTC

Sales and Use Taxation of Digital Products

- <https://www.mtc.gov/Uniformity/Project-Teams/Sales-Tax-on-Digital-Products>
- MTC staff interviews with stakeholders
- Work group is being formed; monthly meetings expected; all are welcome; first meeting 9/22/22
- Whitepaper outline to identify issues
- Coordination with SST
- Uniformity Committee meets in Little Rock, AR – November 15

Uniformity Efforts – Streamlined

Digital Products Sourcing Rules

- Workgroup study: “what happens to sourcing when the seller does not need a street address from the customer (such as a digital goods transaction with electronic delivery/access to the product) and has only a 5-digit zip code from the customer (if that)?”
- <https://www.streamlinedsalestax.org/committees/state-and-local-advisory-council/slac---workgroups>

Legislative Hearings and Research

- 6/14/22 - U.S. Senate Finance Hearing: “Examining the Impact of *South Dakota v. Wayfair* on Small Businesses and Remote Sales”
 - Government Accounting Office (federal) – Post-*Wayfair* impacts on sellers
- 7/18/22 – Council On State Taxation article: State Taxation of Software and Digital Products in Six Categories (available at [COST.org](https://cost.org))
- Fall 2022 - Mississippi DOR report due to state legislature
- TBD – New Jersey DOR report due to state legislature

Regulatory Guidance

- **New Mexico** – Proposal and 9/8/22 hearing to amend regulations to address “[3.2.213.13 Receipts of a Digital Platform that Displays Digital Advertising](#)”
- **Ohio** – [ST 1999-04 - On-line Services and Internet Access - Updated September 2022](#) (addressing ITFA)
- **Pennsylvania** – Update to [Retailer’s Information \(May 2022\)](#) to add NFTs as digital items
- **Washington State** – [Interim statement regarding the taxability of non-fungible tokens \(NFTs\) \(July 1, 2022\)](#)

New Mexico proposed digital advertising rules

- On August 9, the New Mexico Department of Revenue submitted proposed rules regarding the taxation of digital advertising under the Gross Receipts and Compensating Tax Act
 - “The receipts of a provider of digital advertising services, whose digital platform may be accessed or viewed from within New Mexico, from the sale of advertising services to advertisers within and without New Mexico are subject to the gross receipts tax”
 - “The gross receipts tax levied on such advertising receipts does not impose an unconstitutional burden on interstate commerce”
- The term “digital advertising services” is defined as “advertisement services on digital platforms, including advertisements in the form of banner advertising, search engine advertising, interstitial advertising, and other comparable advertising services”
- The term “digital platform” means “any type of website, including part of a website, or application, that a user is able to access or view”

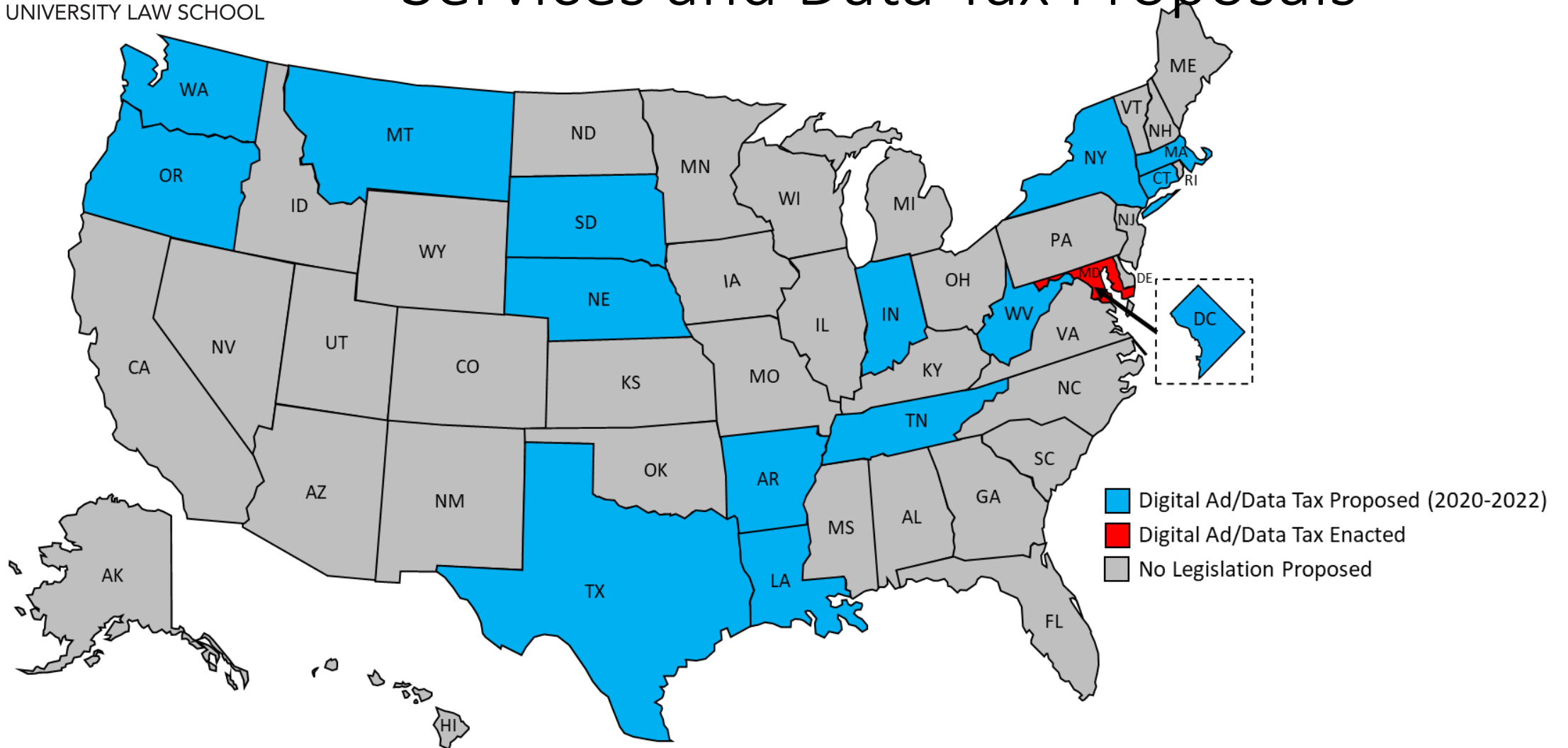
New Mexico proposed digital advertising rules

- The proposed rules provide a deduction for certain digital advertising services when the provider's receipts:
 - Are from a national or regional advertiser not having its principal place of business in New Mexico, or that is not incorporated under the laws of New Mexico, or
 - Are from an advertising agency which purchases the display of advertisements on the platform on behalf of, or for subsequent sale to, a seller defined in (i) above. However, the commissions of advertising agencies from performing services in this state may not be deducted
- A "regional" seller or advertiser is a person who sells from locations in more than one state or who purchases advertising services intended to be heard or viewed in more than one state
- The proposed rules also provide an example which illustrates that a digital advertising service provider's reporting location is based on the location of the server from which the advertising is accessed

Legislative Proposals – Taxes on Digital Advertising Services and Data

- Three categories of proposals from 2020 to 2022 would establish new regimes imposing taxes on “Big Tech:”
 1. Digital advertising services
 - Tax on apportioned gross revenue from digital advertising services
 2. Social media advertising
 - Tax imposed on social media companies’ gross revenue advertising services or number of users
 3. “Data mining” services
 - Tax on companies selling personal information or data, akin to a severance tax

2020-2022 Digital Advertising Services and Data Tax Proposals



- **Disclaimer:** This information should be used for general guidance and not relied upon for compliance.
- **Source:** Council On State Taxation

2022 Digital Advertising Services & Data Tax Proposals

- **2021 Carryover Proposals:**

- **Massachusetts**

- H.2894 (Maryland-style DAT)
 - H.3081 (Maryland-style DAT)
 - H.4042 (Maryland-style DAT)
 - H.4179 (Maryland-style DAT)
 - H.2928 (creates a “digital advertising revenue commission”)

- **New York**

- SB 4959 (AB 6199) (Personal data tax)

- **West Virginia**

- HB 2148 (Data mining service tax)

- **Washington**

- HB 1303 (Personal data tax)

2022 Digital Advertising Services, Digital Goods, and Data Tax Proposals

- **2022 Proposals:**

- **Georgia**

- HB 594 (Digital goods – eff. 7/1/22)

- **Indiana**

- SB 372 (Social media tax)

- **Iowa**

- SSB 3074 (Digital goods and services tax)

- **Kansas**

- HB 2230 (Digital goods)

- **Maryland**

- SB 735 (Digital goods and codes)
 - HB 735 (Digital goods)

- **Missouri**

- SJR 33 (Digital goods)

- **New York**

- A. 734 / SB 302 (Digital advertising)
 - S. 1124 (Digital advertising)

- **Tennessee**

- HB 2482/SB 2380 (Social media tax)

- **Virginia**

- HB 1343 (Digital goods and subscription services tax)

- **Washington**

- HB 2107 (Personal data tax – copy of NY SB 4959)

Proposed Taxes on Digital Advertising Services and Data

What is driving this wave of bills?

1. Social “Big Tech” backlash following 2020 elections centered on both antitrust and perceived free speech concerns
2. Recurring “fair share” arguments
3. Digital ad tax proposed by Paul Romer in a May 2019 New York Times article
4. The Internet Tax Freedom Act’s anti-discrimination provision

ITFA's Anti-Discrimination Provision

- Section 1101 of ITFA preempts “discriminatory taxes on electronic commerce” imposed by state or local governments.
 - As a federal statute with no agency assigned to interpret it, ITFA provides little guidance regarding the meaning of key terms, which places state and local taxes imposed on transactions conducted over the internet at risk of ITFA challenge.
- Section 1105 (2)(A) defines “discriminatory tax” as “any tax imposed by a State or political subdivision thereof on electronic commerce that (i) is not generally imposed and legally collectible by such State or such political subdivision on transactions involving similar property, goods, services, or information accomplished through other means; ...”

Maryland Digital Advertising Tax HB 732 (2020) – Timeline

- March 18, 2020: Passed by General Assembly; vetoed by Governor
- February 12, 2021: General Assembly veto override
- February 18, 2021: Declaratory judgment lawsuit filed by U.S. Chamber and other trade associations in U.S. District Court (more on that later)
- March 14, 2021: Enacted and takes effect; first compliance deadline April 15, 2021
- April 12, 2021: SB 787 passes General Assembly, delaying tax by 1 year

Maryland Digital Advertising Tax HB 732 (2020) - Elements

Tax imposition:

- Imposed on “annual gross revenues...derived from digital advertising services in the State.”
- “Annual gross revenues” means “income or revenue from all sources, before any expenses or taxes, computed according to generally accepted accounting principles.”
- Digital advertising services “includes advertisement services on a digital interface, including advertisements in the form of banner advertising, search engine advertising, interstitial advertising, and other comparable advertising services.”
- “Digital interface” broadly defined as “any type of software, including a website, part of a website, or an application, that a user is able to access.”

Apportionment:

- The new tax provides an apportionment fraction (Maryland digital advertising services annual gross revenue/U.S. digital advertising services annual gross revenue) but provides no starting point which to multiply the fraction by.

Sourcing:

- The enacted tax is silent as to sourcing. The Comptroller is required to adopt regulation that determine the state from which revenues from digital advertising services are derived.

Maryland Digital Advertising Tax HB 732 (2020) – Elements (cont.)

Tax rate:

- Determined based on each entity's **global** "annual gross revenues."
- 2.5% of the assessable base for a person with global annual gross revenues of \$100M through \$1B.
- 5% of the assessable base for a person with global annual gross revenues more than \$1B through \$5B.
- 7.5% of the assessable base for a person with global annual gross revenues more than \$5B through \$15B.
- 10% of the assessable base for a person with global annual gross revenues exceeding \$15B.

Thresholds/Calculation:

- Entity-by-entity determination.
- No obligation for entities with \$1M or less of **Maryland** digital advertising service revenue/year.
- 0% rate for entities with **global** annual gross revenues of less than \$100M.

Maryland Digital Advertising Tax HB 732 (2020) – Elements (cont.)

Declaration and Quarterly Returns:

- Each legal entity that reasonably expects their annual gross revenues derived from digital advertising services in Maryland to exceed \$1M must file a declaration of estimated tax on or before April 15 of that year and file quarterly estimated returns on or before June 15, September 15 and December 15 of that same year.

Payments:

- For legal entities required to file an April 15 declaration and quarterly returns, payment of at least 25% of the estimated tax must be made with the declaration and each quarterly return filed. Any unpaid tax for the year that is calculated as part of the annual return must be paid with the return due April 15 of the following year.

Penalties and Interest:

- *Civil* – Interest (10% annually) **and** up to 25% penalty assessed on unpaid/underestimated tax amount from due date to date of payment if an entity required to pay the tax: (1) fails to pay an installment when due; or (2) estimates a tax that is less than 90% of the tax required to be shown on the return and less than 110% of the tax paid for the prior taxable year.
- *Criminal* – penalties for (1) willful failure to file return and (2) willful filing of false return.

Maryland Digital Advertising Tax SB 787 (2021) – Cleanup Bill

- **Passed General Assembly April 12, 2021** – became law without governor’s signature May 30, 2021
- **Emergency measure** – effective upon enactment
- **Amends Digital Advertising Gross Revenues Tax by:**
 - Excluding digital advertising services on digital interfaces owned or operated by or on behalf of a “broadcast entity” or “news media entity.”
 - Creating a pass-through prohibition: “A person who derives gross revenues from digital advertising services in the State may not directly pass on the cost of the tax imposed under this section to a customer who purchases the digital advertising services by means of a separate fee, surcharge, or line-item.”
 - Delaying the tax to “be applicable to all taxable years beginning after December 31, 2021.”
 - Clarifying that these changes are being made to reflect the intent of the General Assembly at the time of the enactment of Chapter 37 of 2021.
- **Comptroller published Digital Advertising Tax Bulletin within hours of the bill passing on April 12**

Maryland Digital Advertising Tax Regulation (eff. 12/13/21)

Sourcing

- Devices with indeterminate locations are thrown out of the fraction numerator and denominator.
- Device location is determined by the totality of the data within the taxpayer's possession or control, including: "both technical information and nontechnical information included in" the terms of the digital advertising service contract.
- Technical information includes:
 - Internet protocol;
 - Geolocation data;
 - Device registration;
 - Cookies;
 - Industry standard metrics; or
 - Any other comparable information

Regulation's apportionment fraction formula:

$$\frac{\text{\# of Devices That Have Accessed Digital Advertising Services from MD}}{\text{\# of Devices That Have Accessed Digital Advertising Services From Any Location}} \times \text{Taxpayer's Digital Advertising Gross Revenue} = \text{Annual Gross Revenues Derived from MD Digital Advertising Services (Assessable Base)}$$

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Court Cases of Note in the Digital Realm



U.S. Chamber of Commerce et al. v. Franchot Case No. 1:21-cv-00410-DKC (D. Md.)

- February 18, 2021: Complaint filed by four trade associations (U.S. Chamber of Commerce, Internet Association, NetChoice and Computer & Communications Industry Association) filed suit in Maryland U.S. District Court against the Maryland Comptroller in his official capacity seeking to declare the Maryland Digital Advertising Gross Revenues Tax is preempted by federal law and unconstitutional and requests that the court permanently enjoin enforcement of the tax.
- Allegations:
 - Discriminates against electronic commerce in violation of the Internet Tax Freedom Act;
 - Burdens and penalizes extraterritorial conduct occurring outside Maryland with the purpose or effect of discriminating against interstate commerce in violation of the dormant Commerce Clause;
 - Prevents the federal government from speaking with one voice in violation of foreign Commerce Clause; and
 - Violates the Due Process Clause of the Fourteenth Amendment by imposing progressively greater liability on companies for their extraterritorial conduct.

U.S. Chamber of Commerce et al. v. Franchot

- **April 30, 2021 - Amended Complaint Filed**

- In addition to initially-filed causes of action, the amended complaint also alleges:
 - SB 787 pass-through prohibition violates Due Process and dormant Commerce Clauses of U.S. Constitution by directly regulating extraterritorial conduct; and
 - First Amendment violation (pass-through prohibition specific).

- **Briefing completed**

- June 15, 2021 – Defendant’s dispositive motion in response to the amended complaint
- July 29, 2021 – Plaintiffs’ opposition to defendant’s dispositive motion and cross-motion for summary judgment
- Sept. 13, 2021 – Defendant’s reply in support of his dispositive motion and opposition to plaintiffs’ cross-motion for summary judgment
- Oct. 13, 2021 – Plaintiffs’ reply in support of their cross-motion for summary judgment
- Nov. 19, 2021 – State’s supplemental brief (TIA) filed
- Dec. 13, 2021 – Plaintiffs’ response to supplemental brief (TIA) filed
- Feb. 17, 2022 – Oral Argument
- March 4, 2022 – Judge issues order granting Defendant’s motion to dismiss in-part and denying it in-part
- April 4, 2022 – Parties file Joint Status Report leaving First Amendment claim to be addressed
- April 29, 2022 – Parties’ opening supplemental briefs (First Amendment) filed
- May 13, 2022 – Parties’ responsive supplemental briefs filed
- July 12, 2022 – Oral Argument; judge requested additional briefing on the First Amendment issue.

Comcast et al. v. Comptroller

No. C-02-cv-21-000509 (Md. Cir. Ct., filed Apr. 15, 2021)

- Filed by Comcast and Verizon subsidiaries
- Amended complaint filed (Sept. 10, 2021)
- Seeking a declaratory judgment that the digital ad tax:
 - Violates the Internet Tax Freedom Act;
 - Violates the Due Process Clause;
 - Violates the Commerce Clause's fair apportionment requirement and discriminates against interstate commerce; and
 - Improperly delegates taxing authority to Comptroller
- Comptroller filed motion to dismiss (Oct. 12, 2021), response filed by Plaintiffs (Dec. 8, 2021), reply filed by Comptroller (Jan. 27, 2022)
- Hearing scheduled March 14, 2022
- On March 18, 2022, without explanation, the court granted Defendant's motion to dismiss on one count only – the court will not consider Plaintiffs' allegation that the MD General Assembly improperly delegated its taxing authority to the Comptroller with respect to calculating the tax
- On April 5, 2022, Plaintiffs moved for summary judgment, telling the circuit court that the reason MD's DAT is the first, and only, in the nation is because it is unconstitutional in multiple ways, and it violates ITFA.
- Summary judgment hearing scheduled October 17, 2022.

Does the Chicago Amusement Tax Violate ITFA?

- *Apple, Inc. v. City of Chicago, Circuit Court of Cook County*, 2019 CH 03022 (March 11, 2022)
 - In 2015, Chicago broke new ground by targeting streaming services for the Amusement Tax; taxpayer lost its challenge to the tax in the 2019 decision in *Labell v. City of Chicago*, 2019 IL App (1st) 181379.
 - Apple challenged this tax in Illinois Circuit Court with slightly different and more refined arguments.
 - Case settled and Apple will now begin collecting tax on some services.

Does ITFA Trump the TIA?

- *Rubinas v. Maduros*, No. 1:21-CV-00096, 2021 BL 351679 (N.D. Ill. 2021).
 - Does the TIA, which generally bars federal courts from enjoining, suspending or restraining the assessment, levy or collection of any state tax, contains an implicit exception for relief sought under the Internet Tax Freedom Act?
 - Rubinas asserts that federal courts have jurisdiction to hear her claims, despite the TIA, because she is asserting a claim under the ITFA. Rubinas is also claiming that she is not responsible for collecting and remitting use tax pre-*Wayfair*, even if the online marketplace stored their inventory in the customer's state, which is also the taxing state.
 - The Court held that it did not have jurisdiction due to the TIA: "... if Congress meant to exempt Internet Tax Freedom Act claims from its reach, then this exemption needed to be written into the statute. It was not."
 - Taxpayer's motion for a preliminary injunction denied; an appeal to the 7th Circuit is pending.

Does ITFA Apply to iCloud and iTunes?

- ***Apple Inc. v. Hegar, (D-1-GN-20-004108)* in Travis County District Court**
 - Apple argues:
 - Sales/use tax on Data Processing Services does not apply because...
 - Tax data processing definition was written decades ago does not fit Apple's services
 - Apple's services protected by ITFA – Texas does not tax other non-internet providers of storage; i.e., physical storage
 - Internet Tax Freedom Act (ITFA)
 - States may not tax internet access or transactions without taxing similar transactions performed by non-internet business. ITFA says tax covered includes electronic storage.
 - Enacted in 1998, but Texas taxes were grandfathered in (until 2020).

Does ITFA Apply to iCloud and iTunes?

- ***Apple Inc. v. Hegar, cont.***
 - Comptroller estimates potential \$500M annual loss in Texas tax revenue
 - Comptroller argues:
 - Tax on Data Processing Services turns on use of computer, not use of internet
 - Data storage is data processing, and iTunes/iCloud provide data storage.
 - If court finds ITFA is discriminatory, it should be struck down as interfering with states' rights and/or violating the anti-commandeering doctrine
 - "ITFA is a direct order to state gov'ts to refrain from taxing internet transactions. ITFA is unconstitutional."
 - **District Court Decision issued 6/16/22: both parties' MSJs denied.**

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Looking into the SALT Crystal Ball: Where are we headed?



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Questions?

Karey Barton
Managing Director
KPMG LLP
kareybarton@kpmg.com

Nancy Prosser
General Counsel
Multistate Tax Commission
nprosser@mtc.gov

Chris Wilson, Partner
Waller Lansden Dortch &
Davis, LLP
chris.wilson@wallerlaw.com