

STATEMENT
OF
RUSS BRUBAKER
TAX POLICY ADVISOR
WASHINGTON DEPARTMENT OF REVENUE

ON BEHALF OF
THE FEDERATION OF TAX ADMINISTRATORS

BEFORE THE

SUBCOMMITTEE ON COURTS, COMMERCIAL AND
ADMINISTRATIVE LAW
OF THE COMMITTEE ON THE JUDICIARY
UNITED STATES HOUSE OF REPRESENTATIVES
ON
THE DIGITAL GOODS AND SERVICES TAX FAIRNESS ACT
OF 2011 (H.R. 1860)

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Introduction

Chairman Coble, Vice Chairman Gowdy, Ranking Member Cohen and members of the Subcommittee, thank you for the opportunity to address the Subcommittee concerning The Digital Goods and Services Tax Fairness Act of 2011 (H.R. 1860). I am Russ Brubaker, Tax Policy Advisor for the Washington Department of Revenue. Today, I am testifying on behalf of the Federation of Tax Administrators (FTA). FTA is an association of the tax administration agencies in each of the 50 States, the District of Columbia, and New York City.

Summary

FTA strongly opposes H.R. 1860 because the bill would create a permanently privileged category of sellers who sell goods and services delivered, transferred, or provided through electronic means. The bill does this by prohibiting or “preempting” taxes on:

- Very broadly defined sales of digital goods and services, designated as “purchases for resale,”
- Sales of digital goods and services if the tax is imposed on sales where the seller resides, (i.e. “origin” basis taxes) without providing remote collection authority,
- Sales of digital goods and services that are subject to specified rates of tax that are incorrectly characterized as “discriminatory” or “multiple” taxes, and

- Sales of digital goods and services by certain intermediaries including fulfillment companies, billing or electronic transfer service companies.

FTA recognizes that Congress has an interest in making sure that there are no real impediments to interstate commerce. Current state tax law, however, creates no such impediments. There is virtually no evidence that states are imposing taxes that discriminate against sales of digital goods and services or that the states are imposing multiple taxation on these items. Rather, such goods and services have been omitted under most state tax systems in years past, while similar goods, and only selected services, delivered through traditional means have been taxed. This bill establishes a Federal framework for the state taxation of digital goods and service. There simply is no genuine need that would warrant this extensive Federal legislation that reaches to the very limits of the Commerce Clause itself, effectively imposing limits on the taxation of purely local activity.

Because terms such as “resale” and “discriminatory” are both extremely broad and only vaguely defined in the bill, and because there is little room for them to be further defined through authoritative administrative guidance, the bill will inevitably result in expensive open-ended litigation that will prevent state tax collections for years and prevent authoritative guidance for businesses on their tax obligations. The bill will also interfere with the ability of state and local governments to develop equitable tax systems that match new sales and marketing techniques and will have negative fiscal impacts for these jurisdictions.

The bill, unlike other Congressional preemptive state tax legislation, is retroactive. Congress would be breaking new ground by authorizing the invalidation of existing state taxes.

Finally, digital goods and services represent a developing area of commerce. Where this industry is going and how it will develop is not yet well enough understood, even by the participants of this industry. Any kind of preemption at this time and of this type is both unwise and dangerous. This bill would establish immutable rules for digital goods and services without any real understanding of the implications of how these new regulatory rules will impact the states or the economic decisions of businesses providing these digital products. This is a complex and difficult area and the only way to address state taxation in an effective way is for the business community to work with the states to create a fair and mutually acceptable tax model that is both responsive to the needs of states and business and allows for flexibility in the future. Moreover, there are acceptable existing forums for this type of cooperation and even existing efforts to address some the issues included in this bill.

There Is No Multiple Taxation Under Current Law

Simply stated, there is currently little issue with multiple taxation on sales of digital goods or services that burden interstate commerce. For example, all states that impose sales and use taxes allow credits for taxes paid to other jurisdictions. This is a necessary

prerequisite for the tax to be deemed constitutional under existing law.¹ This principle is applied in the context of other state tax types as well. In fact, the proponents of this bill have identified no genuine threat of multiple taxation that would require this type of legislative response. In short, this bill is a solution looking for a problem.

Taxes on Digital Goods and Services are Generally Favorable, Not Discriminatory

Some states impose taxes on digital goods and services under the very same rules for taxing traditionally delivered goods and services and so have established parity in taxation between digital and non-digital products. About half the States do not impose taxes on digital goods and services, or do not impose tax if those goods and services are delivered electronically, even though they impose such taxes on other similar or traditionally delivered goods or services. In these states digital goods and services benefit from discrimination in their favor. For example, a state might impose sales tax on canned software purchased in a retail store on a disk, but not on the same software purchased and delivered electronically over the Internet. *The reality is that digital goods have largely escaped taxation up to this point* and have thus enjoyed a competitive advantage compared to non-digital products. Again the proponents of this bill have raised no genuine threat of discrimination that would require this type of legislative response.

Adverse Effects on Local Businesses and Preferential Treatment of Certain Industries

This legislation will give large multi-state businesses and Internet sellers a further competitive advantage over local businesses. Sellers who have a physical presence in a state (traditional retail sellers) will have to continue to collect or pay tax on sales of digital goods and services to customers in that state, as they do now. Multi-state and Internet sellers who do not maintain a physical presence in a state and who can deliver the digital good or service from a “remote location” (electronically) can avoid paying or collecting sales taxes already today.² This bill further ensures that sales made by these businesses *cannot, in many instances, be taxed in the state where the sale originates, that is, where the seller is located*. As a result, traditional “Main Street” sellers could be at a significantly worse competitive disadvantage than they are today compared to Internet and other types of remote sellers if these sellers structure their operations to avoid tax

Moreover, the focus of this bill is not some essential difference in a product or service, but rather in the way that the good or service is delivered. The bill provides protections and preferences for goods and services that are transmitted or provided electronically. So, for example, this bill imposes no limitations on how states can tax financial services

¹ See *Henneford v. Silas Mason Co.*, 300 US 577, 581, 57 S. Ct. 524 (1937) and *Oklahoma Tax Commission v. Jefferson Lines, Inc.*, 514 US 175, 194, 115 S. Ct. 1331 (1995). See also *State Taxation: Third Edition*, Walter Hellerstein, Chapter 18 (2009) in

² *Quill Corp. v. North Dakota*, 504 US 298, 112 S. Ct. 1904 (1992) (States may not impose a sales or use tax collection obligation on out-of-State sellers with no physical presence in the State).

delivered to an instate customer by a local bank branch, but does impose limitations if that very same service is delivered to that same customer electronically.

Exclusion from Tax of Certain Businesses

It also appears that the bill would provide preferential treatment to certain kinds of businesses. The bill preempts the imposition of taxes (broadly defined) on digital goods and services that are imposed on anyone other than a “seller” or a “customer.” Under the bill, a “seller” does not include certain intermediaries. This ignores the fact that these intermediaries provide services themselves that are likely to be deemed “digital services” under the bill. For example, a fulfillment company could perform a digital service of transmitting a digital good for the seller of that digital good. That separate digital service would be entirely excluded from tax because the fulfillment company is not a “seller.” While it does not appear that this was the intent of the bill, not only does this “loophole” allow some types of businesses to avoid any tax on their goods or services but it would also allow corporations to restructure and take advantage of the same unintended benefit.

For example, Online Travel Companies (OTCs) may act as intermediaries in providing reservations for hotel and other local goods and services. That reservation service would be considered a “digital service” under the bill. That service would not be taxable at all under the “taxpayer limitation” since the OTC would not be a “seller” under the bill’s definitions. This is an example of how the bill would impact current activities, but combined with the bill’s sourcing rules and the lack of authority for states to impose tax on remote sellers, would make it possible for corporations to use controlled affiliated entities to perform certain intermediary services and avoid taxes in many cases.

This exclusion of intermediaries from any state tax poses a substantial risk for the future of state tax enforcement. Internet commerce has changed how business is done. Sales are often made through intermediaries who look very much like traditional sellers, and serve many of the same functions (advertising goods for sale, delivering goods, billing and collecting payments), but who never take title to the goods and services of third parties that they offer for sale on their web sites, and therefore would not be considered the “seller” under this bill. In many cases, the intermediary is the logical and most practical person to collect sales tax from the customer. In some cases, the intermediary may be the only person that can perform this function. To exclude them completely from any tax payment or collection obligation will effectively exclude a substantial, and quickly expanding, area of commerce from state tax.

Reduced State Revenues, Expensive Litigation, and Constitutional Questions

The bill will significantly impact state revenues, now and in the future, and will inevitably lead to very expensive and protracted litigation with the potential of Federal courts effectively legislating for the states. There is at least some question of whether the scope of the preemption in the bill is permissible under the Commerce Clause of the U.S. Constitution.

Reduced State Tax Revenues. The bill will have serious impacts on state tax revenues. For example:

- *Problems with Nowhere Sales.* The provisions of the bill that create a new tax advantage for digital goods and services, which benefit primarily large Internet sellers over local retailers, will also create a significant amount of sales activity that is not taxable by any state—otherwise known as “nowhere sales.” A state where the seller is located will not be able to tax the sale if the customer is outside the jurisdiction, because the bill would preempt that tax, and the state where the customer is located may not be able to tax the sale if the seller has no physical presence in the state. Conceptually, the destination based sourcing model in the bill may have merit, but ultimately this model cannot be considered as a national solution while the states are prohibited from imposing tax on sellers without a physical connection. Otherwise, sellers who deliver digital goods and services through electronic means will be able to avoid state tax through simple restructuring of their businesses and limiting of their physical presence. The consequence of this approach would be a further reduction in state tax revenues.
- *The “Resale” limitation and tax base erosion.* The bill seeks to eliminate tax on purchases for resale. The language describing purchases for resale is broad and not well defined. The bill will prohibit taxation of transactions and activities that many states tax today. For example, in the state of Washington the bill would entirely preempt business and occupation taxes imposed on licensing digital goods and services under the royalties classification, despite the fact these taxes do not discriminate against digital commerce or impose multiple taxes on the same transaction.
- *Retroactive impacts.* Unlike other preemption bills considered by Congress, this bill would apply to all existing taxes and thus place in jeopardy legally enacted state statutes. Additionally, the bill would not protect the states with respect to taxes imposed in past periods unless those taxes were both “accrued” and “enforced.” Both of which are undefined terms. As a result, it is clear to see that the retroactive aspects of this bill will have a negative impact on past, present, and future state tax collections.
- *Impact of restructuring to take advantage of the bill’s provisions.* As discussed above, because certain intermediaries are completely excluded from tax on their own digital goods and services, this limitation in combination with other provisions of the bill would make it possible for businesses to restructure in order to limit or avoid taxes in many cases.

Expensive Litigation. The bill will lead to years of litigation to try to resolve its terms. Unlike the typical statute passed by Congress, there is little ability for any administrative agency to further interpret the terms or provide guidance to address the kinds of questions that are bound to arise. Instead, the bill leaves it up to the Federal courts to resolve all questions solely through the long, expensive process of litigation. This will further cost the states, be a boon for litigators, and will further benefit large sellers over small ones.

More importantly, if a Federal court determines a particular tax to be “discriminatory,” the court may have to effectively usurp the typical legislative role of the states in order to provide a remedy. This is especially true since the bill requires a determination of the effective tax rate based on a whole range of taxes, fees and charges, not just the traditional sales and use taxes, so that a determination of whether there is any discrimination may involve multiple state laws and the weighing of different tax burdens such as credits, deductions, and similar items.

The bill’s focus on digital equivalents will further exacerbate these problems. As it reads today, the bill would require digital goods and services to be taxed at the same effective tax rate as their non-digital equivalents. This equivalency concept simply does not translate to the real world. For example, it is very simple to compare the sale of a music Compact Disc to the sale of an album in mp3 format. However, the comparison becomes more difficult when songs from the same album are streamed with other songs to a customer who has subscribed to a service that selects music for the customer based on their previous listening habits. Is the customer buying the song or the song picking? Many, if not most, digital goods and services are headed toward not having a tangible equivalent. Therefore, this bill will plunge the states, businesses, and the courts in an endless stream of litigation designed to prove individual products have digital equivalents and therefore are protected.

The kinds of questions that will undoubtedly require litigation will include:

- What is a resale? If a business purchases software that it uses and also provides access to customers to use, is this a resale? What if the business does not charge specifically for that access?
- What constitutes a digital equivalent?
- What exactly is a digital good? Is all software a “digital good” or only software that is delivered electronically?
- Can States treat software sold on a disk differently than software sold and delivered over the Internet?
- Since a service is a “digital” service by definition when it is “delivered electronically” does this allow sellers to convert traditional services into “digital” services simply by delivering a final report or other product by e-mail?
- How will products including both digital and non-digital components be treated?
- What does the term “generally imposed” taxes mean? That term is defined as a tax that is not imposed only on specific services, specific industries or business segments, or specific types of property. Defining these terms will lead to virtually endless litigation.
- The term “tax” includes fees. Does this mean every fee, even fees that are only specifically imposed on certain businesses or industries that are covered by the bill?
- The term “digital services” does not include telecommunications, but states define telecommunications differently as does the federal government in other areas. A significant number of “digital services” will use or be closely related to telecommunications services so this ambiguity is especially problematic.

These are just a few of the questions that will inevitably lead to litigation in Federal courts creating additional uncertainty and costs for the states.

Constitutional Questions. The bill would clearly preempt imposition of any tax on an in-state purchaser of digital goods or services if that purchaser can be said to have purchased the good or service for “resale.” Therefore, the state or local jurisdiction where the purchaser uses the good or service may not be able to impose a use tax on that purchaser, even where the good or service was also purchased from an in-state seller. Whether the imposition of a purely local tax on a purely local activity, in this case the use of the good or service, is the appropriate focus of Congress in the exercise of its Commerce Clause authority is doubtful. The bill’s proponents appear to recognize the questionable constitutionality of this bill, having included a savings clause that would preserve portions of the bill not found unconstitutional.

Sourcing Issues and the Problem with the “Resale” Limitation

Sourcing issues. The bill incorporates a destination based approach to the sourcing of digital goods and services. The language appears loosely based on language developed under the Streamlined Sales and Use Agreement (SSUTA) and adopted by 21 states. However, the bill is not identical to the SSUTA (see addendum), deviating from it in very significant ways. Therefore, the bill simply creates a new layer of regulation for businesses in these states. Moreover, these rules would entirely preempt states that source sales based on origin concepts. While there may be merit to establishing a uniform method of sourcing for digital goods and services, this bill is not the right way to achieve that result. Instead, the business community and states must work together to create a fair and mutually acceptable tax model that is responsive to the needs of states and business and considers the models that already exist. In fact, there are already acceptable existing forums for this type of cooperation and even existing efforts to address this issue.

Problems with the “Resale” Limitation. States may tax business purchases of goods and services for a number of reasons, even where it could be argued that the good or service is resold in some form or fashion. Because it is often very difficult to determine whether a good or service is actually resold, states typically use other “bright-line” criteria instead of simply relying on a term like “resale,” when allowing exemptions for business purchases. In contrast, the bill defines a “purchase for resale,” as any purchase of a digital good or service “for the purpose of reselling it,” *or* using it as component of another digital good or digital service. Moreover, resale includes any retransmission. This definition is woefully deficient and raises a number of questions. How is the seller to know whether the purchaser has a “purpose” of reselling the digital good or service? What if the purchaser’s “purpose” is to both use and resell the good or service? What if the resale is not in the ordinary course of purchaser’s business? Can a purchase for retransmission be treated as a resale even if the transfer is not part of an actual sale. (The use of the words “and includes” retransmissions in the definition seems to indicate that this is the case.)

The problem of distinguishing between the purchase of digital goods and services for “resale” is compounded with the bill’s adoption of a very broad definition of digital goods and services. “Digital goods and services” are delivered *or transferred* electronically,” as well as “electronically provided,” and include software, information maintained in digital format, digital audio-visual works, digital audio works and digital books, plus virtually unlimited types of services.

Bundling Assumption

The bill implies that sales of digital goods and services are not subject to retail sales tax unless bundled with a service or tangible personal property subject to sales tax. This is unlike Steamlined rules and rules in other states that allow a state to subject bundled sales to tax when the nontaxable product is bundled with the taxable digital good or service.

Mr. Chairman, that concludes my testimony. Thank you again for the opportunity to appear before the Subcommittee.

Addendum

Below is a list of differences between H.R. 1860 and the Streamlined Sales and Use Tax Agreement (SSUTA). Some of the differences are already covered in the written testimony even if they do not reference SSUTA.

1. SSUTA only applies to sales and use tax while the bill applies to any tax, charge, or fee other than net income and property taxes.
2. The definition of “digital good.”
 - a. The bill includes software.
 - b. SSUTA does not include software as a digital good. In fact, it specifically states that prewritten software is tangible personal property, even when delivered electronically. SSUTA did this so the well-established tax treatment of software would not be disturbed.
3. The definition of “digital good.”
 - a. The bill defines digital goods as only goods that are transferred or delivered, not provided, electronically.
 - (1) This appears to mean that downloaded music is a digital good, but streaming music is a digital service.
 - b. SSUTA defines digital goods as data, facts, information, sounds, and images whether they are transferred, delivered, or provided electronically (although SSUTA uses a broader definition of “transferred” to encompass delivered and provided).
 - (1) This means that downloaded music and streaming music are both digital goods (in most cases).
 - (2) How a song is accessed generally doesn’t matter.
4. User rights are not addressed directly in the bill, but are addressed in SSUTA.
5. SSUTA does not interfere with state administration and state adjudication processes, while the bill does interfere through the establishment of federal court jurisdiction
6. SSUTA is not retroactive. This bill is retroactive.
7. SSUTA excludes ancillary, telecommunication services, tangible personal property, and software from digital goods and services. The bill excludes tangible personal property, telecommunications service, Internet access service, and audio or video programming service.