taxnotes® state

Volume 113, Number 9 ■ August 26, 2024

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Reprinted from *Tax Notes State*, August 26, 2024, p. 569

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In this article, the authors explore the complexities of state taxation in the digital economy and offer insights into navigating these challenges effectively in this space.

The digital economy has revolutionized the way we engage with products and services, leading many businesses to adopt operating models such as "freemium" and ad-supported digital goods and service offerings. These models rely less on physical presence and place greater value on consumer data. Subscription-based services frequently bundle an assortment of digital goods and services, delivering a wide array of products for one monthly or annual price.

Traditionally, U.S. state transaction tax systems were designed to apply to the sale of tangible goods. States and localities are stretching to apply these legacy tax systems to the sale of digital products and services. Some states have amended their governing laws and regulations to provide clarity regarding the application of transaction tax to digital sales. However, in other jurisdictions, revenue departments have announced aggressive administrative interpretations without legislative countenance. These developments, coupled with the advent of third-party online marketplace models, have created a complex web of transaction tax treatments that providers of digital goods and services must carefully navigate.

Most recently, many state legislatures are considering proposals to enact new taxes (in addition to existing transaction and income tax regimes) on digital advertising, social media advertising, and data mining services. These efforts have persisted despite the fact that Maryland's enactment of a digital advertising tax has been embroiled in litigation and has been declared unconstitutional by the only court to examine the tax on its merits.

As the stakes for taxpayers rise, many have turned to the federal Internet Tax Freedom Act (ITFA) for support in defending against the imposition of taxes designed to target digital commerce. This article explores the complexities of state taxation in the digital economy and offers insights into navigating these challenges effectively in this space.

Sales Taxes for the Digital Economy

States and localities take a varied approach to taxing various components of the digital economy.

Digital Products

This broad category includes digital versions of movies, music, books, and other media. Some states treat digital products like their analog counterparts and impose sales and use tax on them. For example, Texas generally imposes tax on digital products and streaming services, while other states, such as California, exempt digital products and streaming services from tax. Taxation may also differ depending on whether a consumer downloads a digital product to their device or accesses it through a streaming service and whether the consumer has perpetual access to a downloaded digital product or it is merely a rental.

Software

Many states treat prewritten computer software as a type of tangible personal property and impose sales tax accordingly, even if the prewritten software is delivered electronically. In contrast, custom software developed for a specific user is more commonly viewed as a service and thus typically exempt from sales tax.

Video Games and Associated Content

A few states have rules for video games apart from the general rules for software. In addition, states take varying approaches to taxing downloadable content, in-game purchases, and virtual currencies. Some states treat the purchase of virtual currencies like traditional gift cards and impose sales tax when the virtual currency is redeemed for additional in-game content. Other states, including Maryland and Tennessee, have developed unique tax categories for virtual currency, imposing sales tax on the funding of virtual wallets on the theory that these transactions are the sale of an access code.

Cloud Computing

States have been slow to enact legislative amendments to clarify the application of transaction tax to cloud computing services, such as software as a service (SaaS), platform as a service (PaaS), and infrastructure as a service (IaaS), but that has not stopped many states from enforcing their laws as applicable to these services. States take a variety of approaches to cloud computing and may even tax cloud service models (SaaS, PaaS, and IaaS) differently. For example, New York treats SaaS as prewritten software subject to sales tax, while treating PaaS as a nontaxable service. Alternatively, Wisconsin treats both SaaS and PaaS as nontaxable services.

Digital Advertising and Data Taxes

In addition to traditional sales and use taxes, many state legislatures are considering whether to enact laws imposing new taxes on digital advertising, social media advertising, and data mining services. These new taxes capitalize on advertising-based business models, which predominately fall outside the scope of historic transaction taxes but are taxed as part of state income tax regimes. Maryland has enacted a first-of-its-kind domestic tax on digital advertising services, modeled off digital service taxes that have been imposed by other countries. Maryland's tax has been tied up in litigation for years, while a wide range of other states are considering proposals. In the 2023 and 2024 legislative sessions, California, Connecticut, Illinois, Indiana, Iowa, Kentucky, Massachusetts, Nebraska, Nevada, New York, Rhode Island, Tennessee, and the District of Columbia have considered tax legislative proposals in three main categories.

Digital Advertising Services

These legislative proposals seek to tax apportioned gross revenue from digital advertising services. States that have followed Maryland with similar proposals have attempted to "fix" some of the legal and constitutional issues that exist with the Maryland law. For example, Nebraska L.B. 1354/L.B. 388, considered in 2024, would impose a 7.5 percent gross revenue tax on all advertising services (not just digital advertising) sourced to Nebraska earned by taxpayers with more than $1 billion in U.S. gross advertising receipts. Only time will tell whether the "fixes" solve the legal problems or simply open the door to new challenges to these punitive taxes.

Social Media Advertising

Other proposals seek to tax social media companies' gross revenue from advertising services or number of users. These taxes are often similar to a more broadly applicable digital advertising tax but are limited to just "social media companies," thereby gaining increased support from legislators and commentors critical of the leading social media companies. Many view these proposals as more "political statements" than serious tax proposals. However, they continue to be proposed and, with the right political winds, are a threat that must be carefully monitored.

Data Mining Services

These proposals are new taxes on companies collecting or selling personal information or data. New York's S.B. 2012 (A.B. 3959) is an example of one such tax. That proposal would impose a graduated monthly excise tax on the collection of New York consumers' data by entities that collect data (other than basic contact information) on more than 1 million New York consumers within a month. The D.C. Tax Revision Commission has also recently added a data excise tax on the collection of District resident data to the list of recommendations it is considering finalizing and submitting to the D.C. Council later this year. Data mining tax proposals are gaining in popularity and are likely to be introduced en masse as 2025 legislative sessions kick off later this year. The proposals can have an unexpectedly broad impact, imposing taxes well beyond the Big Tech companies that legislatures often intend to target. For example, a large grocery store, brick-and-mortar retailer, or restaurant chain's customer loyalty program that records data on purchases could be subject to a data mining services tax.

ITFA Defenses to State Taxation

First enacted by Congress in 1998 and made permanent in 2016, ITFA was designed to preempt state and local taxes that could impede the growth of the digital economy. By imposing a moratorium on taxes related to internet access and those that discriminate against electronic commerce, ITFA promotes the free flow of interstate commerce over the internet. ITFA provides critical defenses against state and local overreach in taxing the digital economy. The act has two prongs of its permanent tax moratorium on states and localities: (1) antidiscrimination and (2) internet access. Each prong limits state and local efforts to impose excessive or discriminatory taxes on the digital economy.

Antidiscrimination Prong

This prong preempts discriminatory taxes on electronic commerce. ITFA defines discriminatory taxes as those that burden e-commerce but that would not be generally imposed and collectible by a state or locality on similar tangible property, goods, and services. The antidiscrimination prong ensures that digital transactions are not taxed more heavily than their offline counterparts. This could include not only the imposition of the tax itself, but also differences in rates on the person obligated to collect or pay the tax. The antidiscrimination prong has been central to litigation against Maryland's digital advertising gross revenues tax and has been raised in other cases in which the state or local tax being imposed does not apply to peers and competitors with similar offerings that aren't delivered via the internet. For example, the Louisiana Board of Tax Appeals recently ruled that an online audio streaming service was not subject to local tax because the tax did not apply to satellite radio and thus was a "discriminatory tax on electronic commerce" under ITFA.[1] Given how state and local tax administrators and policymakers have pieced together the tax obligations applicable to the digital economy, the antidiscrimination prong is frequently helpful and should be carefully explored with your SALT adviser.

[1] *See Apple Inc. v. Samuel*, Dkt. No. L01283 (La. Bd. Tax App. May 6 2024).

Internet Access Prong

The second prong of ITFA's state and local tax moratorium prohibits taxing jurisdictions from imposing taxes on internet access, which was defined by Congress in 2007 to include certain enumerated categories of products and services provided independently from colloquial internet access packages, including a homepage, email (including voice- and video-capable email), instant messaging (including voice- and video-capable instant messaging), video clips, and personal electronic storage capacity.[2] This prong is designed to protect consumers from additional costs and to preserve the internet as an open platform for commerce and communication. If taxpayers can show that their activities are within the enumerated categories, they are exempt from state and local taxes under this prong. For example, in *Apple Inc. v. Samuel*,[3] Apple successfully argued that its iCloud service was personal electronic storage capacity within the meaning of the "internet access" ITFA prong and thus not subject to local sales tax by operation of federal law. In *Petition of Verizon New York Inc.*,[4] an administrative law judge ruled that the gross receipts tax on transportation and transmission corporations could not be applied to revenues from asymmetric digital subscriber line and fiber broadband services, as these services are federally preempted under ITFA. The ruling emphasized that Congress intended the ITFA to be a broad prohibition on taxing any form of internet access, using the definition of "Internet access" from ITFA rather than the state tax law. The judge rejected the department's narrow interpretation of internet access services, which only included services provided to end-user consumers, noting that such an interpretation failed to account for evolving technology.

Conclusion

Complex state and local tax issues will continue to arise in the sphere of digital taxation as product offerings expand and as states and localities adapt their taxing systems to a digital world. Taxpayers should closely monitor states' transaction tax frameworks for application to digital goods and services, monitor the enactment of new taxing schemes, and consider applicable defenses, including the ITFA. Consulting tax professionals can help navigate this complex landscape effectively. ■

[2] *See* ITFA section 1105(5)(E).

[3] *Apple Inc.*, Dkt. No. L01283 at 4.

[4] *Petition of Verizon New York Inc.*, DTA No. 829240 (N.Y. Div. Tax App. May 4, 2023).