MULTISTATE TAX COMMISSION

MEETING NOTES

MTC Work Group – Sales Taxation of Digital Products
January 23, 2025

I. Introductions and Review of Notes from November 7, 2024 Work Group Meeting

Tim Jennrich (Washington), Chair of the Work Group, convened the meeting noting a new record for a table tennis rally set recently (13 hours or so). Tim also noted that it is National Pie Day.

Tim also stated that the group's process guidelines and notes from the November 7 meeting were posted on the project page and that anyone with changes to those notes should contact Helen Hecht, at hhecht@MTC.gov.

II. Initial Public Comment

Jennrich invited any initial public comments. There were none.

III. Report on the Bundling Study Group

Jennrich moved to discussion of the bundling study group and turned the meeting over to Work Group Vice Chair Mia Strong (Louisiana) to provide a preliminary report on the bundling study group's activities.

Mia reported that the bundling study group had 12 states participating and that it was limited to state participants plus Craig Johnson, Streamlined Executive Director. Mia stated that the study group had held one substantive session and had worked through half of the examples. She mentioned the next study group session is on January 27, 2025, where it will discuss the remainder of the examples.

Mia then covered some initial and preliminary takeaways. One was that it was clear that the way Streamlined has set it up there are multiple ways to escape out of the Streamlined bundling rules. This meant that there was broad agreement on what was and what was not a bundle but that there were multiple ways to get to that answer. The study group saw some variation on that.

Mia noted that questions about the tax base came up and showed that the question of bundling cannot be completely removed from what the state imposes tax on. She noted that there were different perceptions of what constituted one nonitemized price but that the issue seemed to be with the facts rather than the rules. She noted that in many real world cases these facts would be worked out, for example, during the discussions with the taxpayer about a letter ruling request.

Finally, Mia noted that the de minimis exception got a lot of attention and was mentioned on every example in one way or another. She noted that there were differing views of the de minimis exception and that Craig Johnson, Streamlined Executive Director, had noted that the de minimis exception might need more detail. Mia concluded her report, noting that the study group would meet again on January 27, to go over additional examples and then turned back to Tim.

Tim asked Diane Yetter (Sales Tax Institute) about feedback from non-state participants, noting that she had mentioned some examples at a prior meeting. She mentioned an example of a business that provides published information that is also used for continuing education credits separate from the publishing and that may also involve SAAS. She stated there are other interesting examples and that she would review the bundling exercises and determine if there was anything she wanted to add to the study group's discussions.

Mia also noted that the study group had raised questions about when something is an essential component of some other items sold.

IV. Proposed Definitions Study Group

Tim then moved discussion to the proposal for a second study group on definitions. Tim discussed some of the work group's prior related work, including the tax base and imposition research. He reminded the work group of their earlier agreement to support two study groups on the topic of definitions, one for each model. One group would study the broad approach and the other would study the narrow or incremental approach. Tim stated that the study group covering the broad approach was meant to be organized through this work group and the MTC while the narrow one was proposed to be organized through Streamlined but would also involve any non-Streamlined states that wanted to participate in discussions. He stated he would be reaching out to Craig at Streamlined to discuss how they may want to address the narrow approach. Tim then stated his intention to discuss how the MTC work group would organize the broad approach study group and to hear a substantive proposal.

Tim then turned to Ray Langenberg (Texas) to discuss that proposal. Ray stated he was not representing his agency or advocating for that agency or for the adoption of any tax. Ray then reiterated the charge to the work group from the Uniformity Committee, which is to consider "the ways that digital products might be defined, categorized, exempted, and sourced." He stated that regardless of whether defining something makes it easier to tax it, states are already doing this, so it would be helpful to look at it with some forethought rather than waiting until the pressure is on, either from the legislature or otherwise. He also noted he thought this was a good exercise for everyone and welcomed any and all input.

Ray stated his belief that there is a need for this, noting that states are moving this way already. He identified the problem as the fact that digital products blur the line between traditional tangible personal property (TPP) and services. He proposed a separate category that is untethered from those old categories.

Ray identified various criteria often used to define a tax base, including any exemptions, listing some of those as: output, input, who is buying, who is selling, and intended use, and some unlisted others. He then stated his proposal focused on the input ingredients. [See the slides explaining that proposal as well as the document summarizing it on the MTC project page.]

His proposal, as updated, is a definition of an automated digital product. Defined as an item, including software and service, that is provided for noncommercial use in a binary format, and for which the additional human intervention to produce a similar item for additional customers is minimal. He stated his intention was to have others consider this and improve it.

Ray then walked through his three criteria. The first criterion is binary format. He stated this was the essence of a digital product. He included “including software and services” just to make clear that the distinction between TPP and services is being abandoned by this definition. He stated that as defined the term potentially overlaps with the old concepts of TPP and services.

The second criterion is “noncommercial use.” Ray stated this criterion was to prevent the pyramiding of taxes. He noted that pyramiding is a primary concern of many groups, and he wants to show that it is possible to deal with that concern. He noted that he baked the noncommercial requirement into the definition to avoid the need for an exemption.

He stated this carveout from the definition is broad and imperfect but counseled against allowing the perfect to become the enemy of the good. He stated this exclusion from the definition is a practical way to get rid of pyramiding and supports his intention to create a definition that is political feasible and practicable.

He specifically addressed intangible rights, like digital publishing or performing rights, that would be commercial, so the exclusion deals with intangible rights in large part. He noted a second advantage of avoiding many sourcing difficulties as the most difficult sourcing issues come from sales to businesses, for example, allowances for multiple points of use.

The third criterion is minimal human intervention. Ray explained this is to address the marginal increase in human intervention required to create an additional item. He stated this will make the proposal more compatible with the current systems where professional and other services are largely untaxed. He stated his intention to propose something that is feasible for the legislature to adopt. He noted that many states tax TPP and have added software to the definition of TPP, while his proposal essentially adds other digital products.

Ray noted that the United Nations, the Organization for Economic Co-operation and Development, and the European Union have all used “minimal human intervention” or “involvement” so the group would not be starting from scratch on these ideas. These organizations have worked on this and have examples of the application of these concepts which can be used to create rules right away.

Ray also noted that his proposal makes no formal allowance for the limitations of the Internet Tax Freedom Act (ITFA). He stated his belief that states should not tailor their laws around the ITFA, noting that ITFA or its interpretation could change. Ray stated he believes it is better to acknowledges ITFA’s preemptions through rules rather than to embed it in the statute.

Ray then noted that there is no requirement of electronic delivery in his proposal and that one reason for this is to avoid raising issues under the multiple and discriminatory provisions of ITFA. He noted that making electronic delivery over the Internet a requirement would increase ITFA risk. Without an electronic delivery requirement, the rule is less likely to be viewed as singling out the Internet for taxation.

Finally, Ray mentioned that states could use the proposed definition but only actually tax some subset of that definition, by also enacting exemptions, to control the expansion of the tax base to what they desire. Ray then concluded his remarks and turned the meeting back over to Tim. Tim thanked Ray for his proposal and invited feedback.

Josh Pens (Colorado) asked about the commercial use criterion. He asked if that was based on the nature of the use or something else. Josh mentioned that the same software could be an automated digital product, or not, based on the use case which makes it more like an exemption. He also mentioned the similarity to the "food for home consumption" criterion and may similarly require constant attention.

Ray responded he did not define commercial use in his proposal, he instead left the concept intentionally vague. He agreed it could function as an exemption. He stated he structured it the way he did because he wanted a single concept with everything in one place. Plus, he thought baking the commercial criterion into the definition might be more palatable to the business community.

Mark Nebergall (Softec) brought up the lack of a requirement for electronic delivery and asked for an example. Ray replied that a compact disc was one example. Mark noted that this would be TPP under most states' rules and Ray agreed and reiterated that the proposal is not intended to be perfectly exclusive of the existing categories of TPP and services.

Mark then moved on and recommended the group consider borrowing definitions of common terms like consumer from the Uniform Commercial Code. Ray noted this recommendation.

Ray then reiterated that he recommends moving away from the traditional notion of TPP and services. Mark mentioned that SaaS never gets delivered and so a delivery requirement might be an issue. Ray stated his proposal does not use the word delivered, it uses provided, and again reiterated the need to move away from the traditional notions if the work group intends to discuss anything meaningful. He also noted that the definition is meant to clearly distinguish services, which most states have not chosen to tax broadly.

Tim mentioned Washington has a minimal human involvement requirement that uses "primarily." Tim mentioned he liked the use of the binary protocol as part of the definition but might want to say "any successor protocols" to future proof it just in case. Tim also mentioned he liked the approach of not building ITFA into the statute. He also mentioned the Wisconsin provision that provides that "to the extent the tax violates ITFA, then the similar item is intended to be taxable or exempt" to try to address the ITFA uncertainty.

Diane Yetter noted that she likes the use of "commercial" in the definition but documenting that the use is commercial may require treating as we do many exemptions. She asked whether we would need the kind of exemption documentation to establish who the product is sold to and used, and how will we do that. She mentioned the subscription model, sometimes sold to a person, the doctor or lawyer or accountant, but used for commercial use. How does the supplier know that it is for commercial use?

Richard Dobson (Kentucky) noted that this new definition, using different boundaries, will have to be considered in light of existing exemptions. If it is not TPP, then it might not qualify for the other exemptions and that will take some analysis.

Tim then moved to the next steps. He mentioned that the group has discussed it and wants as many perspectives as possible from the start but also wants the group to remain at a manageable size. Tim said he would ask staff to make a request for volunteers and move from there.

Jeff Friedman (Eversheds) spoke up with an observation on what he referred to as a top-down approach versus a bottom-up approach. Jeff said Streamlined used the bottom-up approach, and these rules were relatively narrowly tailored. The definition Ray proposed is the opposite, likely on purpose. Jeff said the traditional notions are foundational and very important and that TPP and delivery are important and so putting those aside when defining digital products it could be a much more difficult political lift. He asked the group to consider whether this is too heavy a political lift. Ray responded that he agreed that feasibility is important, and this is why he addressed the commercial use and the minimal human intervention in the definition.

Tim then turned to Helen Hecht (MTC). Helen stated that the staff will start off by creating information for would-be volunteers. She noted that with the bundling study group, the exercises and expectations were provided with the call for volunteers. She stated that with this proposed study group, the staff will develop an outline, notes, or some other resource to summarize what has been proposed and inform the volunteers of what they are getting into. She mentioned one option is for volunteers to take what the MTC staff produces and compare it to their states' tax systems to help inform them if the definition would be workable or what issues they could bring to the study group.

Tim reiterated that Ray's proposal is just a proposal, not the proposal, and that if others have proposals then the group will consider those as well.

Tim stated the February work group meeting was cancelled meaning the work group will meet next on March 6, 2025. He stated the goal is for the bundling study group to provide its full report at that meeting.

V. New Business

Tim moved to discuss any new business, there was none.

VI. Adjourn

Tim then adjourned the meeting.