TAXATION OF DIGITAL GOODS AND SERVICES

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INTRODUCTION

Have you ever listened to the latest hits from your favorite artist on Spotify or Beats Music? Or read an e-book on your Kindle? Or perhaps you are even contemplating streaming the newest season of *House of Cards* on Netflix or *Game of Thrones* on HBO instead of reading this Note. If you answer yes to any of the above, you are not alone. Digital content is becoming an increasingly ubiquitous part of our modern lives, and its consumption is growing exponentially,[1] quickly surpassing that of its physical counterparts. In 2008, 10 million electronic books were sold in the United States.[2] Four short years later that number rose to 457 million,[3] and Amazon announced that its Kindle e-book sales surpassed print sales in both the United States and the United Kingdom.[4] In 2014, the music industry saw a 13.3.% decrease in physical music album sales, from 89.5 million in 2013 to 77.6 million in 2014; over the same period, the number of digitally streamed songs increased by 54% from 106 billion in 2013 to 164 billion in 2014.[5] Market watchers report that video streaming services are also growing quickly and are poised to replace traditional cable television.[6] Fifty-four percent of total

1. According to the Association of American Publishers and the Book Industry Study Group, e-book and digital music sales rose 44% and 9.1% respectively in 2012. *See* Melanie Hicken, *Are You Paying the iTunes Tax?*, CNN MONEY (June 5, 2013, 12:24 PM), http://money.cnn.com/2013/06/05/pf/taxes/itunes-tax/?iid=EL#TOP.

2. *E-book Sales are up 43%, but That's Still a 'Slowdown'*, USA TODAY (May 16, 2013, 11:16 AM), http://www.usatoday.com/story/life/books/2013/05/15/e-book-sales/2159117/?AID=10709313&PID=6154686&SID=14rqn2wl5pki9.

3. *Id.*

4. Jason Kincaid, *That Was Fast: Amazon's Kindle Ebook Sales Surpass Print (It Only Took Four Years)*, TECHCRUNCH (May 19, 2011), http://techcrunch.com/2011/05/19/that-was-fast-amazons-kindle-ebook-sales-surpass-print-it-only-took-four-years/; Adario Strange, *Amazon U.K. E-Book Sales Surpass Print*, PCMAGAZINE (Aug. 7, 2012, 8:37 AM), http://www.pcmag.com/article2/0,2817,2408135,00.asp.

5. NIELSEN, 2014 NIELSEN MUSIC U.S. REPORT 1–2 (2015), *available at* http://www.nielsen.com/content/dam/corporate/us/en/public%20factsheets/Soundscan/nielsen-2014-year-end-music-report-us.pdf.

6. *Digital TV, Movie Streaming Reaches a Tipping Point*, EMARKETER (Apr. 2, 2013), http://www.emarketer.com/Article/Digital-TV-Movie-Streaming-Reaches-

bandwidth usage in peak evening hours are from streaming videos[7]—an amazing feat considering the versatility of the Internet.

As you are enjoying your digital content, did you consider what exactly you are paying for? Is it a good or service? Or are you creasing your brows at these inane questions and wondering why it should matter? The differentiation is important for state and local taxing authorities because goods and services are often taxed very differently. And if you are uncertain about whether digital content is a good or service, then you are in good company. When the Organisation for Economic Co-operation and Development (OECD) studied the tax challenges posed by our now digital economy, it recognized the prevalence of retailers selling digital goods and services.[8] The report found the line between goods and services increasingly blurry, as digital content continues to evolve and to grow more ubiquitous.[9] In addition, the tax challenge becomes more complex as the industry expands from traditional retailers to innovative service providers such as educational institutions.[10]

As more consumers switch to digital music, books, and movies, states increasingly lose tax revenue from decreasing physical sales.

Tipping-Point/1009775; Paul Snyder, *The Future of Cinephilia: Will Streaming Movies Replace DVD*, HUFFINGTON POST (May 25, 2011, 4:40 PM), http://www.huffingtonpost.com/paul-snyder/the-future-of-cinephilia_b_601437.html.

7. Lily Hay Newman, *35 Percent of Total Bandwidth Usage in the Evenings Is from Everyone Watching Netflix*, SLATE (Nov. 21, 2014, 4:01 PM), http://www.slate.com/blogs/future_tense/2014/11/21/new_sandvine_report_shows_that_35_percent_of_evening_bandwidth_usage_is.html ("A report . . . shows that '34.9 percent of downstream traffic in peak evening hours' in North America is from Netflix use. In contrast, only 14 percent is from YouTube, 2.58 percent is from Amazon Instant, 1.41 percent is from Hulu, and 1 percent is from HBO Go.").

8. ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, ADDRESSING THE TAX CHALLENGES OF THE DIGITAL ECONOMY 74–75 (2014) [hereinafter OECD REPORT], *available at* http://www.oecd-ilibrary.org/taxation/addressing-the-tax-challenges-of-the-digital-economy_9789264218789-en. Some examples of digital content include downloadable and streaming music and movies, executable code, games, and services based on data processing. *Id.*

9. *Id.* at 58.

10. The OECD report noted that universities, tutor services and other education service providers now are able to provide courses remotely through streaming and video conferencing, which "enables them to tap into global demand and leverage brands in a way not previously possible." *Id.* at 72. Examples of those services include online bar preparation courses offered by companies such as BARBRI, KAPLAN, and Themis as well as online *juris doctor* programs offered by some law schools. Even traditional law schools such as New York University are offering online courses for LLM students in selected programs to facilitate their studies while working part- or full-time. *See* N. Y. Univ. Sch. of Law, *Executive LLM in Tax*, http://www.law.nyu.edu/llmjsd/executivellmtax (last visited May 5, 2015).

This increases pressure to tax digital content.[11] However, governments worldwide[12] find that taxing digital products is especially challenging because digital products are often "a mix of an intangible product and a service" and therefore do not fit neatly into most existing tax laws.[13] To make matters worse, many states have developed widely variant and incoherent taxing approaches, making for a patchwork national system.[14] This became especially evident in the recent "Netflix cases" that have emerged in various states.[15]

This Note will study the taxation of digital goods and services. The following discussion is divided into four parts. Part I lays out the backdrop for the discussion by examining the restraints currently placed on state and local government taxation by the Constitution and federal laws. It addresses the extent to which digital goods and services *can* be taxed. Part II focuses on policy goals such taxation may serve and discusses whether taxation *should* be imposed. Part III studies *how* digital content should be taxed. It surveys the various states' approaches and analyzes the two most prominent proposed federal solutions—the Marketplace Fairness Act (MFA)[16] and Digital Goods and Services Tax Fairness Act (DGSTFA)[17]—to determine the extent to which they satisfy the constitutional restrictions identified in Part I and the policy goals identified in Part II. Finally, Part III makes a recommendation for taxing digital content.

11. *See* Hicken, *supra* note 1 ("As consumers switch to digital music, books and movies, many states discovered that they were losing out on valuable sales tax revenue and decided to do something about it . . . .").

12. The city of Buenos Aires levied a controversial three percent tax on Netflix streaming video, inciting objections from Argentine president Cristina Fernández de Kirchner who cited fairness and constitutionality concerns. *See* William Hoke, *President Pans Buenos Aires 'Netflix Tax,'* 75 TAX NOTES INT'L 821 (2014) (discussing the constitutionality of the tax); Lorenzo Miquel, *'Netflix Tax' Receives Wad of Criticism from Lawyers, Users*, BUENOS AIRES HERALD (Sept. 4, 2014), http://www.buenosairesherald.com/article/168872/'netflix-tax'-receives-wad-of-criticism-from-lawyers-users (discussing the controversial reaction to the tax).

13. Cara Griffith, *Nuts for Netflix – Taxing Streaming Video*, FORBES (Mar. 28, 2014, 10:25 AM), http://www.forbes.com/sites/taxanalysts/2014/03/28/nuts-for-netflix-taxing-streaming-video/.

14. *See id.* (discussing the "variety of [taxation] methods" adopted by states around the country).

15. David Sawyer, *Netflix Streaming Suits Highlight Tax-Tech Mismatch*, TAXANALYSTS (Mar. 24, 2014), http://www.taxanalysts.com/www/features.nsf/Features/1160843DD2BF9FED85257CA70048C0D1?OpenDocument (discussing the litigation in Kentucky and Louisiana).

16. The Marketplace Fairness Act, S. 698, 114th Cong. § 2(b) (2015).

17. Digital Goods and Services Tax Fairness Act of 2013, H.R. 3724, 113th Cong. (2013).

This Note argues that digital products create unique challenges for state taxing authorities and that a federal solution is needed. Proposed federal legislation, such as the MFA and DGSTFA, take steps in the right direction but are insufficient in numerous ways. In particular, neither proposal alone addresses the entire issue. The MFA's sourcing rules are mainly targeted towards the sale of tangible goods and are therefore inadequate in addressing the complexities of taxing digital content. While the DGSTFA focuses more on the taxation of intangible goods, it is too narrow to address the general issue of taxing remote Internet sellers. However, passing both bills with modifications to address their inconsistencies resolves the issue.

This Note also suggests that Congress take steps to close loopholes in both bills that can easily be manipulated to evade taxes, and that it modify parts of each bill to improve uniformity among the states. Specifically, key terms throughout both pieces of legislation are defined in reference to state and local law, which may lead to widely differing tax bases and to increased compliance burdens for sellers. Lastly, the combination of voluntary compliance and a weak incentive structure undermines MFA's effectiveness. It can be modified to make the grant of taxing authority exclusive to participating states thereby stimulating states' participation.[18]

I.
CONSTITUTION AND FEDERAL STATUTES: PREEMPTION AND LIMITATIONS

Because there is no federal sales tax, state and local governments have enjoyed exclusive taxing power over sales but have only began really harnessing this power since the Great Depression, when traditional sources of revenue such as income and property taxes provided increasingly inadequate yields.[19] However, this tax-

18. Although the current MFA does not provide non-participating states with taxing authority over remote sellers, it does not prohibit it either. Leaving judicial branches to interpret such ambiguity can be dangerous, particularly because most states already claim taxing authority. *See infra* notes 163 and 164 for a complete list of states that claim such taxing authority.

19. WALTER HELLERSTEIN, STATE TAXATION ¶ 12.02 (3d ed. 2014), *available at* 1999 WL 1398963 (discussing the origin of the state and local sales taxes); *see also* JOHN F. DUE & JOHN L. MIKESELL, SALES TAXATION: STATE AND LOCAL STRUCTURE AND ADMINISTRATION 1 (2d ed. 1994) (explaining that states turned to sales tax as "a desperation measure" for a new form of financing).

ing power is still constrained by the Constitution and federal law.[20] This section will examine limits on states' ability to tax digital content.[21]

A. Constitutional Limitations on State Taxation of Streaming Content

The Supreme Court has recognized two primary and interrelated constitutional restraints on states' taxing powers: the Due Process Clause and the Commerce Clause.[22] The Due Process Clause requires that states establish a minimum connection with the person, property, or transaction they are seeking to tax and that states' apportionment formulas be internally and externally consistent. The Dormant Commerce Clause, on the other hand, prohibits state taxes from discriminating against interstate commerce. Additionally, similar to the Due Process Clause, it also requires that states have minimum nexus to the taxpayer. The following sections will examine the two clauses in greater detail.

1. Due Process Clause

Under the Due Process Clause of the Fourteenth Amendment, no state may "deprive any person of life, liberty, or property, without due process of law."[23] The Supreme Court has interpreted the clause to require "fundamental fairness of governmental activity."[24] In the context of a state's taxing powers, the due process nexus analysis focuses on whether the "individual's connections with a State are substantial enough to legitimate the State's exercise of

20. Some state constitutions may also limit powers to tax intangible services. However, this Note does not address this issue because states can more easily amend their constitutions.

21. This paper will survey the current law as background and will not focus on the constitutional question of the minimum nexus or substantial nexus required for a state to tax interstate commerce. There has already been much excellent and informed discussion on the topic. *See, e.g.*, Adam B. Thimmesch, *The Illusory Promise of Economic Nexus*, 13 FLA. TAX REV. 157 (2012); Bradley W. Joondeph, *Rethinking the Role of the Dormant Commerce Clause in State Tax Jurisdiction*, 24 VA. TAX REV. 109 (2004).

22. *See* Quill Corp. v. North Dakota, 504 U.S. 298, 305 (1992). A third constraint is the Foreign Commerce Clause, but the analysis is similar to that under the Commerce Clause. *See* Japan Line, Ltd. v. Cnty. of L.A., 441 U.S. 434, 451 (1979) (holding that state and local taxes must not prevent the federal government from "speak[ing] with one voice when regulating commercial relations with foreign governments"); Anthony J. Colangelo, *The Foreign Commerce Clause*, 96 VA. L. REV. 949 (2010) (presenting the scope of the foreign commerce clause).

23. U.S. CONST. amend. XIV, § 1.

24. *Quill*, 504 U.S. at 312.

power over him."[25] In an oft-quoted passage, the Court announced that "due process requires some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax."[26]

In *Quill Corp. v. North Dakota*, the Supreme Court held that physical presence is not necessary for a non-resident to establish minimum contacts to the state.[27] The person need only have "purposefully availed" itself of the benefits of the economic market of the forum state.[28] While *Quill* is the most recent Supreme Court guidance on the requirements the Due Process Clause imposes on state taxation, it is informed by the Court's personal jurisdiction cases.[29] The two personal jurisdiction rulings issued by the Supreme Court in 2011, *McIntyre v. Nicastro*[30] and *Goodyear v. Brown*,[31] are particularly instructive, underscoring that the key inquiry is whether the company has "purposefully directed" activity toward a state.[32]

The Due Process Clause also requires states' apportionment formulas to be internally and externally consistent.[33] Internal consistency requires that, if the formula were consistently applied by every state, a taxpayer would not be taxed on more than 100% of its income.[34] External consistency requires the formula to apportion to each state only its fair share of a multi-state taxpayer's income.[35] Nonetheless the Supreme Court has been quite permissive, upholding a state apportionment formula in *Container Corp. v. Franchise Tax Board* despite a 14% margin of error.[36] The Court has offered little guidance regarding how much discretion states are allowed. In the only other case on the subject, *Hans Rees' Sons, Inc. v. North Carolina ex rel. Maxwell*, the Court remanded because a taxpayer was

25. *Id.*
26. Miller Bros. Co. v. Maryland, 347 U.S. 340, 344–45 (1954).
27. *Quill,* 504 U.S. at 308.
28. *Id.* at 317 (citing Int'l Shoe Co. v. Washington, 326 U.S. 310, 316 (1945)).
29. *See* Mary T. Benton & Clark R. Calhoun, *Has the Due Process Clause Gotten Its Groove Back?*, 2012 ST. TAX NOTES 722 ("[N]ew guidance from the U.S. Supreme Court may help bring the due process clause back into the minds of practitioners and judges deciding state tax cases."); Brandon P. Denning, *Due Process and Personal Jurisdiction: Implications for State Taxes*, 2012 ST. TAX NOTES 837 (discussing the impact recent personal jurisdiction cases have on the state tax issue).
30. J. McIntyre Machinery, Ltd. V. Nicastro, 131 S. Ct. 2780 (2011).
31. Goodyear Dunlop Tires Operations, S.A. v. Brown, 131 S. Ct. 2846 (2011).
32. *McIntyre*, 131 S. Ct. at 2783; *Goodyear*, 131 S. Ct. at 2854.
33. Container Corp. of Am. v. Franchise Tax Bd., 463 U.S. 159, 169 (1983).
34. *Id.*
35. *Id.* at 169–70.
36. *Id.* at 184.

taxed on 250% of its income.[37] While the Court has not stated whether the internal and external consistency requirements are limited to the income tax context, any proposed state or federal sales tax should meet those requirements in order to avoid constitutional challenge and as a matter of fundamental fairness.

The two restrictions are also applicable to Congress in designing a federal solution. The Due Process Clause is often more restrictive than the Commerce Clause because Congress cannot "legislate Due Process."[38] Congress can expand Due Process rights but cannot take them away.[39]

2. Dormant Commerce Clause

The Dormant Commerce Clause is a judicially constructed legal doctrine that U.S. courts have inferred from the Commerce Clause under Article I of the U.S. Constitution, which grants Congress the power "to regulate Commerce with foreign Nations, and among the several States."[40] Although the clause did not explicitly limit state regulations concerning interstate commerce, the Supreme Court has long construed it to include such a restraint, reasoning that such a power was granted to the national government, not the states.[41] The Clause prohibits state laws from excessively burdening interstate commerce.[42] Unlike the Due Process Clause inquiry, the Dormant Commerce Clause is principally concerned with national economic unity, the "effects of state regulation on the national economy,"[43] and discrimination against out-of-state sellers.[44] *Quill* and its predecessors have addressed the issue of when a

37. Hans Rees' Sons, Inc. v. North Carolina *ex rel.* Maxwell, 283 U.S. 123, 127–28 (1931).

38. Steven Roll, *State Tax Snapshot: Does the Marketplace Fairness Act Satisfy Due Process Requirements?*, BLOOMBERG BNA (Oct. 7, 2013), http://www.bna.com/state-tax-snapshot-b17179877671/ (quoting Prof. Pomp's opinions on whether the Marketplace Fairness Act may violate the Due Process Clause).

39. *Id.*

40. U.S. CONST. art. I, § 8, cl. 3.

41. *See* Gibbons v. Ogden, 22 U.S. (9 Wheat.) 1, 199–201 (1824); Willson v. Black Bird Creek Marsh Co., 27 U.S. (2 Pet.) 245, 252 (1829).

42. *See Gibbons*, 22 U.S. (9 Wheat.) at 199–201; City of Phila. v. New Jersey, 437 U.S. 617, 628 (1978).

43. Quill Corp. v. North Dakota, 504 U.S. 298, 312 (1992).

44. *See* Hunt v. Wash. State Apple Adver. Comm'n, 432 U.S. 333, 335 (1977) (striking down a North Carolina law targeted towards reducing competition with the state's local apple producers).

state can tax out-of-state persons without violating the Dormant Commerce Clause.[45]

i. Current Jurisprudence

The Dormant Commerce Clause requires that state tax laws do not discriminate against interstate commerce.[46] The requirement is articulated mainly in non-tax cases. The current jurisprudence permits state laws that regulate "even-handedly" to effectuate a "legitimate local public interest" and that have "only incidental" effect on interstate commerce, unless the burden imposed on such commerce is "clearly excessive" in relation to the benefits.[47] In contrast facial discrimination against out-of-state sellers is "virtually *per se* invalid"[48] and only permitted if the regulations meet the high standard of advancing a legitimate local purpose that cannot be adequately served by reasonable nondiscriminatory alternatives.[49]

In addition, the Dormant Commerce Clause also imposes a nexus requirement for states to tax non-residents, which has become the focus of state legislation. In 1967 the Supreme Court articulated a bright-line rule in *National Bellas Hess, Inc. v. Department of Revenue of Illinois* that the Commerce Clause requires physical presence for a state to impose taxation on an out-of-state taxpayer.[50] Ten years later the Supreme Court expanded upon this rule in *Complete Auto Transit, Inc. v. Brady*, holding that the states may only tax out-of-state corporations if a four-prong test is satisfied—that the tax is "applied to an activity with a substantial nexus with the taxing State, is fairly apportioned, does not discriminate against interstate commerce, and is fairly related to the services provided by the State."[51] In 1987 the Supreme Court clarified that a taxpayer who has no property, offices, nor employees in a state may be subject to tax in that state if the activities of the taxpayer's independent contractors establish a sufficient nexus.[52]

45. *Quill*, 504 U.S. at 309; *see also* Tyler Pipe Indus., Inc. v. Wash. State Dep't of Revenue, 483 U.S. 232, 234 (1987); Complete Auto Transit, Inc. v. Brady, 430 U.S. 274 (1977); Nat'l Bellas Hess, Inc. v. Dep't of Revenue, 386 U.S. 753 (1967).

46. *See* Complete Auto Transit, Inc. v. Brady, 430 U.S. 274, 279 (1977).

47. Pike v. Bruce Church, Inc., 397 U.S. 137, 142 (1970).

48. Camp Newfound/Owatonna, Inc. v. Town of Harrison, 520 U.S. 564, 575 (1997) (quoting Fulton Corp. v. Faulkner, 516 U.S. 325, 331 (1996)).

49. New Energy Co. of Ind. v. Limbach, 486 U.S. 269, 278 (1988).

50. Nat'l Bellas Hess, Inc. v. Dep't of Revenue of Ill., 386 U.S. 753, 753–54 (1967).

51. Complete Auto Transit, Inc. v. Brady, 430 U.S. 274, 279 (1977).

52. Tyler Pipe Indus., Inc. v. Wash. State Dep't of Revenue, 483 U.S. 232, 234 (1987).

Following this line of precedents, one would not have been faulted for thinking that as mail-order and e-commerce businesses have developed, the Supreme Court has steadily moved away from the bright line rule articulated in *Bellas Hess*. However, to many Court observers' surprise (and consternation), the Court reaffirmed the rule in 1992 in *Quill*, albeit in a lukewarm manner.[53] Some commentators found the Court to be almost "apologetic" of defending the old rule,[54] acknowledging that its modern Commerce Clause decisions signaled a "retreat from the formalistic stringent physical presence test in favor of a more flexible substantive approach."[55] The Court further conceded that, like other bright-line tests, the *Bellas Hess* rule "appears artificial at the edges."[56] The Court even admitted that, under its contemporary Commerce Clause jurisprudence, it might not have reached the result in *Bellas Hess* "were the issue to arise for the first time today."[57] Nonetheless, despite the Court's misgivings it continued to uphold the rule, citing administrative convenience, reliance interests, principles of stare decisis, and concerns about retroactive application of a new rule.[58] Some speculate that by continuing to uphold the somewhat outdated rule the Court was extending an invitation for a legislative solution by suggesting that Congress is more capable of addressing the problem.[59] Justice Kennedy made the plea more explicit by writing in a recent concurrence opinion that "[i]t is unwise to delay any longer a reconsideration of the court's holding in *Quill*."[60] Regardless of any hopes the Court might have entertained, Congress has not yet acted,[61] and *Quill* left much to be desired as the (current) final word by the Supreme Court. Indeed *Quill* was

53. Quill Corp. v. North Dakota*,* 504 U.S. 298, 299 (1992).

54. HELLERSTEIN, *supra* note 19, at ¶ 6.03 (3d ed. 2014).

55. *See Quill*, 504 U.S. at 314 (quoting *Heitkamp v. Quill Corp.*, 470 N.W.2d 203, 214 (N.D. 1991)).

56. *Id.* at 315.

57. *Id.* at 311.

58. *Id.* at 317.

59. *E.g.*, JOHN R. LUCKEY, CONG. RESEARCH SERV., ORDER CODE RS21537, STATE SALES TAXATION OF INTERNET TRANSACTIONS 5 (2005), *available at* http://www.ipmall.info/hosted_resources/crs/RS21537_050111.pdf; Michael C. Hamersley, Note, *Will the* Bellas Hess *Physical Presence Requirement Continue to Protect Out-of-State Mail-Order Retailers from State Use Taxes in the* Quill *Era?* Quill Corp. v. North Dakota, 46 TAX LAW. 515, 515 (1993); *see also Quill*, 504 U.S. at 318.

60. Direct Mktg. Ass'n v. Brohl, 135 S.Ct. 1124, 1135 (2014). The opinion goes on to say that *Quill* was "questionable even when decided" and "now harms States to a degree far greater than could have been anticipated earlier." *Id.*

61. *But see* The Marketplace Fairness Act, S. 698, 114th Cong. (2015) (legislation currently pending in Congress that would address this question).

nominated as one of "the most maligned Supreme Court tax decisions."[62]

ii. States' reaction to *Quill*

Because *Quill* was decided over twenty years ago and the Internet has greatly changed the face of commerce,[63] the future of the Commerce Clause nexus requirement remains uncertain. In response to this uncertainty, states have begun developing their own individual methods to circumvent this restriction and to tax remote sales.[64] These doctrines are often developed by state supreme courts as issues come up in litigation and, as a result, vary widely and sometimes conflict with each other.[65] Currently there are three major theories allowing states to tax remote sellers: the economic presence test, the common ownership test, and franchising and affiliate agreements.[66]

The first theory is the economic presence test, which holds that the substantial nexus requirement can be established through an entity's economic presence in a state despite a lack of physical presence. Businesses can establish economic presence by having sales, property, payroll, or deriving income from licensing intangible property for use in a given state.[67] This approach was first adopted by the South Carolina Supreme Court in 1993 in *Geoffrey, Inc. v. South Carolina Tax Commission*.[68] The court found that the taxpayer had established the nexus through the presence of its intellectual property within the state and commented that any business that consistently exploited a state's market has satisfied the substantial

62. Paul L. Caron, *Pepperdine Hosts Symposium on the Most Maligned Supreme Court Decisions*, TAXPROF BLOG (Apr. 1, 2011), http://taxprof.typepad.com/_blog/2011/04/supreme-mistakes.html.

63. *See* Emily L. Patch, Note, *Online Retailers Battle with Sales Tax: A Physical Rule Living in a Digital World*, 46 SUFFOLK U. L. REV. 673, 684–85 (2013) (examining the incompatibilities of the rule with a digitalized world).

64. *See, e.g.*, N.Y. TAX LAW §1101(b)(8) (McKinney 2015) (popularly called New York's "Amazon law," which employs a click-through nexus approach, imposing a tax-collecting requirement on retailers who compensate state residents who link to the retailer's website); COLO. REV. STAT. § 39-21-112(3.5) (2015) (requiring remote sellers to provide information about sales and taxes to the state and customers).

65. *See* Lauren Joseph Wolongevicz, New Mexico Taxation & Revenue Department v. Barnesandnoble.com LLC*: Reconsidering the Dormant Commerce Clause in an E-Commerce World*, 91 DENV. U. L. REV. 741, 750 (2014) (discussing diverging approaches among the various states).

66. *Id.*

67. *Id.* at 751–52.

68. 437 S.E.2d 13 (S.C. 1993).

nexus requirement so that taxes can be imposed there.[69] However, the case's treatment of the nexus issue was widely criticized as cursory[70] and led to an outcry from the business community.[71] In an effort to calm the widespread panic and prevent businesses from terminating business operations in South Carolina, the state's tax administration issued Revenue Ruling 98-3 in 1998.[72] This ruling significantly limited the scope of the state law at issue in *Geoffrey*[73] by setting forth a series of examples in which it would not be applicable.[74] While the approach has been rejected by many states,[75] North Carolina,[76] Maryland,[77] and New Jersey[78] have embraced a

69. *Id.* at 18.

70. The court relegated the constitutional issue to a footnote: "Further discussion of the remaining requirements of the Commerce Clause [after substantial nexus] is unnecessary. Our Due Process analysis of the benefits conferred upon Geoffrey applies with dual force here and need not be repeated." *Id.* at 18 n.5; *see also* Richard H. Kirk, Note, *Supreme Court Refuses to Re-Examine Whether Physical Presence is a Prerequisite to State Income Tax Jurisdiction:* Geoffrey, Inc. v. South Carolina Tax Commission, 48 TAX LAW. 271, 276–80 (1994) (criticizing the South Carolina Supreme Court's treatment of the nexus issue). The legal underpinnings of the South Carolina court's decision in *Geoffrey* may be questioned. The court's perfunctory Commerce Clause analysis, which dismissed the significance of *Quill* in a footnote, did not address the considerations that led the Court to reaffirm the physical-presence standard in *Quill*. In *Quill*, the Court noted the benefits of a "bright-line" rule that avoids "[u]ndue burdens on interstate commerce . . . by the demarcation of a discrete realm of commercial activity that is free from interstate taxation." HELLERSTEIN, *supra* note 19, at ¶ 6.11[2] (criticizing *Geoffrey*'s cursory and evasive treatment of the issue).

71. *See, e.g.*, Douglas Poms, Geoffrey, Inc. v. South Carolina Tax Commission*: South Carolina Sticks Its Neck Out and Taxes Delaware Holding Company*, 13 VA. TAX REV. 771, 771 (1994); Michael T. Fatale, Geoffrey *Sidesteps* Quill*: Constitutional Nexus, Intangible Property and the State Taxation of Income*, 23 HOFSTRA L. REV. 407, 449–50 (1994).

72. *See* S.C. REV. RUL. 98-3 (Jan. 21, 1998), *available at* https://dor.sc.gov/resources-site/lawandpolicy/Advisory%20Opinions/RR98-3.pdf ("The purpose of this ruling is to address some of the common questions that have arisen relating to taxpayers concerned about the implication of *Geoffrey*.").

73. S.C. CODE ANN. § 12-7-230 (Supp. 1992).

74. The Department issued an updated list in S.C. REV. RUL. 08-1 (Jan. 11, 2008), *available at* https://dor.sc.gov/resources-site/lawandpolicy/Advisory%20Opinions/RR08-1.pdf, which contained an equally long list of limitations.

75. *See, e.g.*, Miss. State Tax Comm'n v. Bates, 567 So. 2d 190, 194 (Miss. 1990).

76. A&F Trademark, Inc. v. Tolson, 605 S.E.2d 187, 194–95 (N.C. Ct. App. 2004).

77. Comptroller of the Treasury v. SYL, Inc., 825 A.2d 399, 416–17 (Md. 2003) (citing *Geoffrey* with approval).

78. Lanco, Inc. v. Dir., Div. of Taxation, 908 A.2d 176, 177 (N.J. 2006) (interpreting *Quill* narrowly and noting that the *Quill* Court "carefully limited its language to a discussion of sales and use taxes").

similar approach. Some states have gone even further and have held that banking transactions within a state establish a substantial nexus.[79]

The second test allowing states to tax remote sellers is the common ownership test. To satisfy the Commerce Clause, some states including California have accepted that, when an Internet or mail order retailer and an in-state brick-and-mortar business have common ownership, the Internet or mail order retailer has developed a substantial nexus to the state.[80] However, this theory was rejected by other states such as Connecticut[81] and Louisiana[82] in factually similar cases.

The third theory allowing for taxation of out-of-state sellers is an extension of the common ownership test and asserts that taxpayers can establish a substantial nexus through franchise or affiliate agreements with in-state residents.[83] At least thirty states take the position that a business establishes a nexus to a state by licensing a trademark or trade name there.[84] For example, in a landmark case the Iowa Supreme Court found that a Delaware corporation with a principal place of business in Kentucky had established a substantial nexus in Iowa through licensing franchises and therefore was subject to tax there.[85]

79. *See, e.g.*, Tax Comm'r of State v. MBNA Am. Bank, N.A., 640 S.E.2d 226, 235–36 (W. Va. 2006) (holding that an out-of-state bank's solicitation of and providing credit card services to in-state residents was sufficient to establish a substantial nexus); Capital One Bank v. Comm'r of Revenue, 899 N.E.2d 76, 86–87 (Mass. 2009) (adopting flexible economic substance analysis rather than physical presence test in context of financial institution excise taxes).

80. *See* Borders Online, LLC v. State Bd. of Equalization, 29 Cal. Rptr. 3d 176, 190–91 (Cal. Ct. App. 2005); Wolongevicz, *supra* note 65, at 750–51.

81. SFA Folio Collections, Inc. v. Bannon, 585 A.2d 666, 668 (Conn. 1991).

82. St. Tammany Parish Tax Collector v. Barnesandnoble.com, 481 F. Supp. 2d 575, 580 (E.D. La. 2007).

83. *See* Daniel Tyler Cowan, *New York's Unconstitutional Tax on the Internet:* Amazon.com v. New York State Department of Taxation & Finance *and the Dormant Commerce Clause*, 88 N.C. L. REV. 1423, 1429 (2010) (examining New York's approach).

84. Sheldon H. Laskin, *Only a Name? Trademark Royalties, Nexus, and Taxing that Which Enriches*, 22 AKRON TAX J. 1, 9 n.35 (2007) (citing JOHN C. HEALY & MICHAEL S. SCHADEWALD, 2007 MULTISTATE CORPORATE TAX GUIDE I-72 to -74 (2007)).

85. KFC Corp. v. Iowa Dep't of Revenue, 792 N.W.2d 308, 310, 328 (Iowa 2010).

The "affiliate agreements" theory was raised in two cases famously known as the "Amazon tax" cases.[86] New York levied taxes on Internet retailers such as Amazon.com and Overstock.com, arguing that they had established a nexus with the state by entering into affiliate relationships with in-state advertisers that typically provide a referral to Amazon.com or Overstock.com on their websites.[87] The state's highest court, the New York Court of Appeals, upheld the tax, holding that the affiliate agreements amounted to active advertising by the retailers and therefore created a substantial nexus.[88] The U.S. Supreme Court denied certiorari without any commentary.[89]

This approach has been rejected by some other states. For example, the Illinois Supreme Court struck down the state's Main Street Fairness Act of 2011—which required out-of-state retailers to withhold sales tax—holding that it was preempted by the federal Internet Tax Freedom Act.[90] However, the fate of the legislation is uncertain because Illinois planned to reenact the law by broadening it to impose withholding obligations on both electronic and non-electronic out-of-state retailers, presumably eliminating concerns about discriminating against digital commerce.[91] Similarly Colorado's "notification law" was struck down by a federal district court on Commerce Clause grounds.[92] However, the Tenth Circuit subsequently determined that federal courts lack jurisdiction to decide such issues under the Tax Injunction Act.[93] The U.S. Supreme Court disagreed, unanimously holding that the Act does not deny federal courts such jurisdiction.[94] As a result the fate of the Colorado law is still pending on the Tenth Circuit's decision on the mer-

86. Overstock.com, Inc. v. Dep't of Taxation & Fin., 987 N.E.2d 621, 622 (N.Y.) (a combination on appeal of lawsuits brought by Overstock and Amazon), *cert. denied*, 134 S. Ct. 682 (2013).

87. *Id.*

88. *Id.*

89. Overstock.com, Inc. v. N.Y. State Dep't of Taxation & Fin., 134 S. Ct. 682 (2013).

90. Performance Mktg. Ass'n v. Hamer, 998 N.E.2d 54, 54 (Ill. 2013).

91. *See* Paul Merrion, *Illinois 'Amazon Tax' Back from the Dead*, CRAIN'S CHI. BUS. (May 30, 2014), http://www.chicagobusiness.com/article/20140530/NEWS02/140539975/illinois-amazon-tax-back-from-the-dead.

92. Direct Mktg. Ass'n v. Huber, No. 10–cv–01546–REB–CBS, 2012 WL 1079175, at *7 (Mar. 30, 2012); *see also* ERIKA K. LUNDER & CAROL A. PETTIT, CONG. RESEARCH SERV., ORDER CODE R42629, "AMAZON LAWS" AND TAXATION OF INTERNET SALES: CONSTITUTIONAL ANALYSIS 2 (2014).

93. Direct Mktg. Ass'n v. Brohl, 735 F.3d 904, 921 (10th Cir. 2013).

94. Direct Mktg. Ass'n v. Brohl, 135 S. Ct. 1124, 1131 (2015).

its on remand.[95] The Supreme Court's decision is important in keeping open taxpayers' access to federal courts in bringing future challenges to "Amazon laws."

In sum, while the constitutional restrictions on states' powers to tax remote sellers is far from clear, it seems that many states believe such entities should be taxed and are struggling with a viable theory to tax them. This is an important issue for taxing digital content, because unlike physical sales, digital sales may not always satisfy the physical presence test; the transactions occur virtually over the Internet and the distributing company does not necessarily need to have a presence in the state to enter into a transaction with a consumer. Perhaps because of the constitutional uncertainty, states' approaches vary widely. Barring state and local tax credits, which not every state currently gives, the inconsistencies may lead to double taxation.[96] This is not only undesirable but prohibited by the Due Process Clause.

B. Federal Statutes

Congress may also restrict states' ability to tax through federal statutes, which may either explicitly prohibit some state taxation or implicitly preempt it by legislating in the same field. Currently the Internet Tax Freedom Act (ITFA)[97] is the only federal statute that impacts states' abilities to tax Internet streaming, but several others have been proposed.[98]

The original ITFA was passed in 1998.[99] As the Internet became more popular, legislators proposed taxing Internet consumption through a "bit tax" which would tax users based on the amount of data they consumed.[100] Congress recognized that such taxes could slow the growth of the Internet and responded by passing the ITFA to prohibit taxes on Internet services, discriminatory taxes that would only apply when a product is sold online, and some

95. *Id.* at 1134.

96. *See* Comptroller of Treasury of Md. v. Wynne, 135 S. Ct. 1787, 1794 (2015) (striking down Maryland's imposition of double taxation on out-of-state earnings on the grounds that it failed the "internal consistency" test but remaining ambiguous about whether states are required to give tax credits).

97. Pub. L. No. 105-277, tit. XI, 112 Stat. 2681-719 (1998).

98. *See infra* Part III.B.2–3.

99. Internet Tax Freedom Act, Pub. L. No. 105-277, tit. XI, 112 Stat. 2681-719.

100. U.S. GOV'T ACCOUNTABILITY OFFICE, INTERNET ACCESS TAX MORATORIUM: REVENUE IMPACTS WILL VARY BY STATE (2006), *available at* http://www.gao.gov/highlights/d06273high.pdf.

taxes on online transactions from multiple jurisdictions.[101] There is a common misconception that the ITFA prohibits states from taxing digital content. In fact the ITFA does not prohibit state taxes that are administered equally without regard to whether the sale was face-to-face, via mail order, or over the Internet.[102] The original ITFA expired in 2001 but has consistently been renewed by Congress.[103] The current ITFA was recently extended to expire in late 2015,[104] but legislation has been proposed to make it permanent.[105]

One might argue that digital content, such as streaming video, is a purely Internet-based service and thus is exempt from tax under the ITFA. However, such an opinion is not generally accepted[106] because much digital content is a substitute for in-person goods or services. For example, streaming video is a close substitute for in-store DVD rentals and purchases, television, and movie tickets. In-

101. Pub. L. No. 105-277, tit. XI, § 1101, 112 Stat. 2681-719. The restriction partially stems from the concern that states could try to reduce competition for their local businesses by overtaxing digital goods, because the seller of digital goods is less likely to be located in that state. Historically states have engaged in this type of protectionist behavior in similar circumstances. *See* Hunt v. Wash. State Apple Adver. Comm'n, 432 U.S. 333, 335 (1977) (striking down North Carolina law which devised regulations raising the cost of out-of-state apple growers and increasing the market share of in-state apple farmers).

102. Internet Tax Freedom Act §1101(b) ("Except as provided in this section [imposing the moratorium] nothing in this title shall be construed to modify, impair, or supersede, or authorize the modification, impairment, or superseding of, any State or local law pertaining to taxation that is otherwise permissible by or under the Constitution of the United States or other Federal law and in effect on the date of enactment of this Act.").

103. Internet Tax Nondiscrimination Act, Pub. L. No. 107-75, 115 Stat 703 (2001) (extending the Act to Dec. 3, 2004); Internet Tax Discrimination Act, Pub. L. No. 108-435, 118 Stat 2615 (2003) (extending the Act to Nov. 1, 2007); Internet Tax Freedom Act Amendments of 2007, Pub. L. No. 110-108, 121 Stat. 1024 (2007) (extending the Act's expiration date to Nov. 1, 2014); Continuing Appropriations Resolution, 2015, Pub. L. No. 113-164, 128 Stat. 1867 (2014) (extending the Act to Dec. 11, 2014); H.R. REP. NO. 83 (2014) (extending the Act to Sept. 2015).

104. *See* Kelly Phillips Erb, *Internet Tax Ban Ending Soon: Speaker Boehner Hopes to Keep Internet Tax Free*, FORBES (Nov. 12, 2014, 11:04 PM), http://www.forbes.com/sites/kellyphillipserb/2014/11/12/internet-tax-ban-ending-soon-speaker-boehner-hopes-to-keep-internet-tax-free/2/; Grant Gross, *Internet Tax Moratorium Extended Again*, PC WORLD (Dec. 15, 2014, 1:59 PM), http://www.pcworld.com/article/2859872/internet-tax-moratorium-extended-in-us-govt-spending-package.html.

105. Permanent Internet Tax Freedom Act, H.R. 3086, 113th Cong. (2014). The Permanent Internet Tax Freedom Act was passed by the house on July 15, 2014 and is currently under consideration by the Senate.

106. *See, e.g.*, *Didn't the Internet Tax Freedom Act (ITFA) Ban Taxes on Sales over the Internet?*, SALES TAX INST., http://www.salestaxinstitute.com/Sales_Tax_FAQs/Internet_Tax_Freedom_Act_ITFA_ban_sales_taxes (last visited May 16, 2015).

deed the pay-TV industry is estimated to have lost 179,000 customers in just the third quarter of 2014 to streaming services, a steeper decline from the 2013 third-quarter loss of 83,000.[107] This decline in traditional cable services would mean a significant drop in state revenue if states yielded their taxing authority over streaming services. Similarly, e-books and streaming music are also close substitutes for physical books and albums.

II.
SHOULD DIGITAL CONTENT BE TAXED? A POLICY DISCUSSION

This section addresses the reasons why digital content should or should not be taxed. Part A of the section presents the traditional efficiency arguments for aligning the tax treatment of digital and physical products. Part B addresses the unique technical difficulties of taxing digital commerce. Part C examines the argument that digital content should not be taxed or should be taxed selectively for the protection of small businesses. Part D surveys potential policy justifications for imposing differential tax treatments on digital and physical products.

A. *Efficiency*

One of the major arguments for taxing digital content is efficiency.[108] An efficient commodity tax system should reflect *what* is sold, not *how* it is sold. Taxing digital content would serve two efficiency goals:[109] first, leveling the playing field between traditional brick-and-mortar stores and online businesses;[110] and second, clos-

107. Shalini Ramachandran, *Pay-TV 'Cord-Cutting' Accelerates*, WALL ST. J. (Nov. 6, 2014, 7:50 PM), http://www.wsj.com/articles/pay-tv-cord-cutting-accelerates-1415321442.

108. *See, e.g.*, Paul Caron, *Repetti Presents* The Role of Economic Efficiency in Formulating Tax Policy *Today at Layola-Chicago*, TAXPROF BLOG (Nov. 18, 2014), http://taxprof.typepad.com/taxprof_blog/2014/11/repetti-presents.html ("Traditionally, the great democracies of the western world assigned equal weight to distributive justice and economic efficiency in designing a tax system. In the past few decades, however, economic efficiency has dominated the debate about the best design of a tax system in politics and analysis by legal academics." (quoting abstract of Professor Repetti's presentation)).

109. *See* Wolongevicz, *supra* note 65, at 750.

110. *See* Brief for Respondents at 30–31, Overstock.com, Inc. v. N.Y. State Dep't of Taxation & Fin., 987 N.E.2d 621 (N.Y. 2013) (No. 2013-0033), 2012 WL 8666226, at *30–31.

ing the gap between states' expenditure outputs and revenue recovery.[111]

1. Leveling the Playing Field

While there may be good policy reasons for exempting some categories of goods from taxation, it is generally more difficult to justify different tax treatment of the *same* product based on how it is sold unless it is explicitly to encourage a certain mode of purchase. Most economists agree that, absent compelling policy goals, an ideal tax should maximize efficiency by not inducing changes in economic behavior, which creates deadweight losses.[112] Tax loopholes are inefficient because businesses will place a premium on tax-evasive structures or transactions, producing a distorted response to the market and causing businesses to tie up resources in activities that generate no social utility. Not taxing digital content while taxing their physical counterpart would encourage Internet transactions, and businesses would seek to obliterate their physical presence in the taxing states to avoid establishing a nexus. This result should only be encouraged if one believes its benefits warrant the use of a tax subsidy. It is difficult to justify a preference for consumers to stream an Internet movie over renting DVDs or watching them in the movie theater.[113]

Nonetheless an efficient tax system does not necessarily demand that the digital content be taxed in exactly the same way as its physical counterpart. To reach the conclusion that the two taxes must mirror each other requires the underlying assumption that the digital product is exactly the same as its physical counterpart, and many argue that this requirement is not met. Steve DelBianco, executive director of NetChoice, a coalition of e-commerce firms like Yahoo!, Facebook, and AOL, notes that digital content is not simply the digital equivalent of books and CDs.[114] Unlike physical products, most digital downloads cannot be resold, gifted, or

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111. Cowan, *supra* note 83, at 1423.

112. *See, e.g.*, WILLIAM BAUMOL & ALAN BINDER, MICROECONOMICS: PRINCIPLES AND POLICY 392–93 (2011) ("[T]he ideal tax would . . . induce no changes in economic behavior."); Martin S. Feldstein, *Effects of Taxes on Economic Behavior*, 61 NAT'L TAX J. 131, 132 (2008) (asserting that "higher taxes hurt the economy by distorting behavior"); Reuven S. Avi-Yonah, *The Three Goals of Taxation*, 60 TAX L. REV. 1, 1 (2006) (stating that efficiency is one of the three goals of taxation).

113. *See* discussion *infra* Part II.D.

114. Quentin Fottrell, *The Days of Tax-free Digital Content Are Numbered*, MARKETWATCH (Mar. 12, 2014, 8:53 AM), http://www.marketwatch.com/story/prepare-for-more-taxes-on-apps-e-books-and-movies-2014-03-12.

traded.[115] While customers receive a license for many purchased digital files, the meaning of ownership of such products is different from that of a book or DVD.[116] A few states seem to agree with this argument by basing the taxability of the sale of a digital product on whether the customer has received any tangible personal property.[117]

Moreover, the user experience is also reportedly different. Aside from the instant gratification and convenience, digital content also provides a more user-friendly experience. One can easily discover new favorites by browsing through the endless lists websites helpfully sort by genre, artist, or other classifications. Most companies even make recommendations based on users' histories. Many companies now offer a monthly subscription service so it is less costly and guilt-free for users to "walk out" on a movie or discard a book they dislike and start another one.[118]

The digital experience also provides a sublime blend of solitary enjoyment and social interaction. Users are able to personalize the experience and discuss interests with other users via the company's provided forum or "like" and "become a fan" of an artist the same way one "friends" someone on Facebook.[119] While consumers who chose the physical product may also log onto online forums for discussion, the experience is more streamlined and convenient with digital products. Other users opine that digital content, such as e-books, will never be a substitute for the "real thing."[120] Part of the joy of reading is the book itself—"pulling it from the shelf, inspecting its cover, letting it fall open to a random page."[121]

115. *See, e.g.*, Capitol Records, LLC v. ReDigi Inc., 934 F. Supp. 2d 640, 648 (S.D.N.Y. 2013) (holding that digital music cannot be resold).

116. *See* Fottrell, *supra* note 114.

117. For example, Oklahoma deems photography and videography services to be not taxable when the end product is delivered electronically rather than physically. OKLA. TAX COMM'N PRIV. LTR. RUL. 13-013 (July 11, 2013), *available at* http://www.ok.gov/tax/documents/LR%2013-013.pdf; *see infra* "Tax Treatment" Part III.A.2.

118. *See Top Five Movie Subscription Services*, MKVXSTREAM, http://mkvx-stream.blogspot.com/2013/07/top-five-best-movie-subscription.html (last visited Apr. 26, 2015) (listing monthly movie and TV show subscription services, including Netflix, Hulu Plus, and Amazon Instant Video).

119. Paul Snyder, *The Future of Cinephilia: Will Streaming Movies Replace DVD?*, HUFFINGTON POST (May 25, 2011, 4:40 PM), http://www.huffingtonpost.com/paul-snyder/the-future-of-cinephilia_b_601437.html.

120. Bob Minzeheimer, *In a Digital World, Print Books Maintain Appeal* (May 15, 2013, 12:01 AM), USA TODAY, http://www.usatoday.com/story/life/books/2013/05/15/e-books-print-books/2159037/.

121. *Id.*

2. Addressing Diminishing State Revenue

The other argument for taxing digital content is that because consumption of digital content often replaces consumption of traditional products, existing methods of taxation no longer capture sufficient sales revenue, thus eroding the states' tax bases. Some have speculated that, as a consequence, states' revenues are no longer sufficient to satisfy their expenditures,[122] reducing the efficiency of state governments. States either have to pass legislation authorizing taxation of the new forms of commerce to close the loophole or reduce their spending drastically.[123] Indeed three states have proposed tax rate changes contingent on whether the federal MFA—which would allow those states to collect such revenue—passes.[124]

B. Technical Difficulties with Imposing a Tax

One of the most unique problems of taxing digital content is the technical difficulty involved. Because digital content generally comes in the form of intangible goods or services delivered entirely over the Internet, it is difficult not only for states to establish a sufficient nexus to the seller to require it to withhold sales tax, but also to source the income so that it can be taxed in the appropriate state. This is especially problematic because most states employ a destination-based sales tax on interstate transactions,[125] which de-

122. *See* Mitch Daniels, Op-Ed., *The Coming Reset in State Government*, WALL ST. J., Sept. 3, 2009, at A17 (pointing out that decreased state tax revenues virtually mandate a reduction in "the size and scope of . . . state governments").

123. *Id.*; Conor Dougherty, *Falling Tax Revenues Slam States*, WALL ST. J., Sept. 30, 2009, at A4 ("State tax revenues in the second quarter plunged 17% from a year earlier as rising unemployment and reduced spending hurt sales-and income-tax collections . . . .").

124. *See* H.B. 1515, 2013 Leg., 433d sess. (Md. 2013) (applying the sales tax to gasoline unless the state can require the collection of sales tax on sales by out-of-state sellers by December 1, 2015); OHIO REV. CODE ANN. § 5741.03 (2015) (directing that revenue from remote seller tax collection be used to lower income tax rates); VA. CODE ANN. § 58.1-2217 (2015) (reducing the wholesale gasoline tax from 6% to 5.1% if the federal government enacts legislation to compel remote sellers to collect state and local sales and use tax by 2015).; Letter from Scott Walker, Governor, State of Wis., to Wisconsin Congressional Delegation (May 15, 2013), *available at* http://www.standwithmainstreet.com/getobject.aspx?fileletter%20from_Governor_Scott_Walker (supporting the use of any remote seller tax collection revenue to reduce income tax rates).

125. All states other than Arizona, California, Illinois, Mississippi, Missouri, New Mexico, Pennsylvania, Texas, Utah, and Virginia impose destination-based sales tax on interstate transactions. *See, e.g.*, *Sales Tax Rates and Identifying the Correct Local Taxing Jurisdiction*, N.Y. STATE DEP'T OF TAXATION & FIN., http://

fines the source of the transaction as the destination at which the product will eventually be used.

It can be difficult to determine the destination of digital content. With most Internet sales, sellers are provided with a shipping address. While not always accurate, especially for gift purchases, these may serve as a proxy for determining where the product will ultimately be used. However, because digital content is rarely physically delivered, it is hard for sellers to ascertain the destination. Sellers commonly use two methods to make this determination—buyers' Internet protocol (IP) and billing addresses—but neither is without problems.

In the simplest case, the seller is directly streaming the video to the buyer. Even in this scenario, aside from the technical difficulties of obtaining recipients' IP addresses, sellers may also be faced with Internet privacy laws,[126] which may further limit access to such information. Moreover, sellers often reach buyers through intermediary distributors,[127] who may refuse to provide sellers with information about buyers' physical locations. Consumers may also take affirmative steps to maintain "Internet anonymity." Consumers can easily hide their IP addresses by installing programs or firewalls.[128] More advanced users may even use a proxy server so

www.tax.ny.gov/bus/st/sales_tax_rates.htm (last updated Nov. 4, 2013) (explaining that New York State's tax is destination-based); ALA. ADMIN. CODE r. 810-6-3-.35.02 (2015) (sales are considered to be made outside Alabama and cannot be taxed by the Alabama sales tax law if the seller delivers the goods outside the state); *see also* Mark Faggiano, *Origin-based and Destination-based Sales Tax Collection*, TAXJAR (Oct. 3, 2014), http://blog.taxjar.com/charging-sales-tax-rates/ (surveying which states use origin- or destination-based sourcing).

126. For example President Obama is releasing a plan to protect consumers' Internet privacy by adopting a consumer privacy bill of rights, which would restrict businesses' use of consumer information. *See Fact Sheet: Plan to Protect Privacy in the Internet Age by Adopting a Consumer Privacy Bill of Rights*, WHITE HOUSE (Feb. 23, 2012), http://www.whitehouse.gov/the-press-office/2012/02/23/fact-sheet-plan-protect-privacy-internet-age-adopting-consumer-privacy-b.

127. For example, at a Massachusetts Department of Revenue public comment hearing regarding its proposed market-based sourcing regulations for intangible products, the Motion Picture Association of America represented that cable and satellite providers are often unable or unwilling to provide information regarding the location of the customer. *See* Robert E. Weyman, Michael A. Jacobs & Brent K. Beissel, *Massachusetts Market Sourcing Update: Report from Public Hearing on Market Sourcing and Special Industry Apportionment Regulations*, REED SMITH (Dec. 4, 2014), http://www.massachusettssalt.com/2014/12/massachusetts-market-sourcing-update-report-from-public-hearing-on-market-sourcing-and-special-industry-apportionment-regulations/.

128. *See* Allen Gilnes, *Making Your IP Address Anonymous*, TOP TEN REVIEWS (Jan. 7, 2010), http://privacy-software-review.toptenreviews.com/making-your-ip-

that, when a website requests the user's IP address, the proxy server's IP address will appear instead of the user's.[129]

As an alternative, sellers may use the buyers' billing addresses as a proxy for the streaming product's destination. This is the approach used by most states,[130] but also has problems. Savvy buyers wishing to evade sales taxes may easily change their billing address to a state that does not impose a sales tax. This is especially easy to accomplish with today's movement toward "paperless billing," so that consumers do not even need to forward the bills to their actual address. Alternatively some consumers may simply want to maintain their Internet anonymity and may choose to use services like Venmo, which offer buyers an option to make payments without providing a billing address to the seller.[131]

Even if sellers are able to ascertain the accurate addresses of customers, there may be issues of how to divide up the sales tax proceeds among states. The mobility allowed by digital content offers users the freedom of going about their travels or daily lives while still being able to stream their desired Internet content. With ubiquitous high-quality Internet access nowadays, it is possible that one may be streaming the same movie across many state or even country lines. For example, an iTunes user may start watching a movie while waiting for a plane in California, board the plane to New York, and continue to watch the movie on the plane. The movie would be watched in more than ten states, depending on the route of the plane. Assuming the Internet server can even detect this information, should the revenue be equally divided amongst the ten states, or should it be apportioned by the segment watched in each state?

Or, making matters more complicated, if the customer uses a monthly subscription service such as Netflix and frequently travels, how should the subscription fee be apportioned across states in which the customer has watched the movies? Even assuming that the states can reach a consensus about how such tax revenue should be divided, is it economically worthwhile to do so? For example some websites such as Amazon offer some older movies at a fairly

address-anonymous.html (teaching readers how to make their IP addresses anonymous).

129. *Id.*

130. *See* Hicken, *supra* note 1.

131. *How It Works*, VENMO, https://venmo.com/about/product/ (last visited May 16, 2015).

low pay-per-view rate of $0.99 to $2.99.[132] While it may be cost-effective for big businesses such as Amazon to trace the exact segment of the movie watched in each state, the cost might be too high for smaller businesses that do not benefit from Amazon's economies of scale. And even further assuming this is technically feasible and not cost-prohibitive, would requiring either the sellers or buyers to so accurately trace the location where the movie is being watched defeat the very point of using digital content, which some argue is at least marketed primarily to allow users more mobility and convenience?[133] It is also questionable whether such complicated taxing schemes would meet the requirements of the Commerce Clause.

Although it may be argued that sellers may address this problem by requiring customers to provide the accurate location in which the streaming product will be used, it is difficult to ensure the accuracy of the information buyers provide. Sellers may even enact a policy refusing to serve customers who do not cooperate in good faith to ensure accurate sourcing. However, in today's economy, it is doubtful that many businesses are in the position to turn down customers and refuse the subsequent revenue generated.

The technical difficulties of imposing a tax on digital content can be addressed in one of two ways: either not imposing a sales tax on digital content or adopting a simplified uniform federal solution. While not taxing digital content may be the simplest solution since it requires no additional governmental action, it cannot be justified solely on the basis of administrative convenience. Such a solution would also cause additional efficiency problems such as differing tax treatments of the same type of goods and may deplete states' tax revenue. Although a federal solution may be more difficult to design, it would serve the efficiency goals discussed above of closing the gap between state expenditures and revenue accrual and leveling the playing field between traditional brick-and-mortar stores and Internet businesses.

132. *See, e.g.*, *Sabrina*, AMAZON, http://www.amazon.com/Sabrina-Humphrey-Bogart/dp/B000IZ6P8I/ref=SR_1_7?s=instant-video&ie=UTF8&qid=1424385070&sr=1-7 (last visited May 16, 2015) (offering the classic Audrey Hepburn movie *Sabrina* for $2.99), *Meet Me in St. Louis*, AMAZON, http://www.amazon.com/Meet-St-Louis-Margaret-Obrien/dp/B002M87W2W/ref=sr_1_28?s=instant-video&ie=UTF8&qid=&sr=1-28 (last visited May 16, 2015) (offering *Meet Me in St. Louis* for $2).

133. *See* Chuck Tryon, *'Make Any Room Your TV Room': Digital Delivery and Media Mobility*, 53 SCREEN 287, 290 (2012).

C. Protecting Small Businesses

One of the major objections to the MFA, a proposed bill that allows states to require out-of-state sellers to collect sales tax,[134] is the burden it would impose on small businesses.[135] The fear is that the compliance burdens of ascertaining the correct withholding rates would create an unfair disadvantage for small businesses because of the constantly evolving laws of the forty-five taxing states and hundreds of localities. While big Internet companies like Netflix and Amazon would also be faced with the same burden, the cost would not be as crippling because of their economies of scale. This is also a unique problem for taxing digital content because, unlike traditional retailers, small online businesses do not operate out of physical storefronts. A small online business may, despite its size, have customers all over the United States and therefore be subject to the taxing regimes of many jurisdictions.

Much federal legislation, including the tax code, provides special relief for small businesses.[136] For example stimulus acts have allowed small businesses special deductions and accelerated depreciation of expenses,[137] ERISA currently allows small businesses to take advantage of Simplified Employee Pension plans that reduce compliance burdens and increase flexibility,[138] and the securities laws contain simplified filing requirements and initial public offering procedures for small businesses under the JOBS Act.[139] Those provisions demonstrate our national concern for not over-burdening small businesses, considered to be a pillar of economic growth. This concern has also been cited by the Supreme Court in *Bellas Hess*, an early nexus case, holding that "the many variations in rates

134. *See infra* Part III.B.2.

135. Steve DelBianco, *The Marketplace Fairness Act: Too Close a Call*, FORBES (Dec. 10, 2014, 4:34 PM), http://www.forbes.com/sites/realspin/2014/12/10/the-marketplace-fairness-act-too-close-a-call/.

136. *See, e.g.*, 26 U.S.C. § 408(k) (2012) (authorizing Simplified Employee Pension Individual Retirement Accounts Contribution); IRS FORM 5305-SEP (Dec. 2004), *available at* http://www.irs.gov/pub/irs-pdf/f5305sep.pdf.

137. *See Stimulus Acts*, SECTION179.ORG, http://www.section179.org/stimulus_acts.html (last visited Mar. 31, 2015) (discussing 50% bonus depreciation for exempt businesses with over two million dollars in assets and unprofitable small businesses).

138. *See SEP Retirement Plans for Small Businesses*, U.S. DEP'T OF LABOR, http://www.dol.gov/ebsa/publications/SEPPlans.html (last visited Mar. 31, 2015).

139. LEE POLSON & LORI ANN FOERTSCH, SPECIAL REPORT: FEDERAL JOBS ACT SEEKS RELIEF FROM SECURITIES REGULATION OF SMALLER BUSINESSES (Strasburger 2012), *available at* http://www.strasburger.com/wp-content/uploads/2013/10/Federal-JOBS-Act-Seeks-Relief-from-Securities-Regulation-of-Smaller-Businesses.pdf.

of tax, in allowable exemptions, and in administrative and record-keeping requirements could entangle . . . interstate business in a virtual welter of complicated obligations to local jurisdictions with no legitimate claim to impose 'a fair share of the cost of the local government.'"[140] Interestingly when *Bellas Hess* was decided in 1967, there were merely eight different rates of sales and use taxes in the United States.[141] The Supreme Court reiterated this concern in *Quill*, in language that some have interpreted to encourage congressional action.[142]

The concern is certainly valid because smaller companies generally have access to fewer resources than bigger companies and do not enjoy the same economies of scale. Few small online businesses have the luxury of maintaining in-house tax compliance counsel, not to mention tax-planning experts. Even those that do must spread the cost across fewer products, resulting in a higher cost per product, thus reducing their competitive edge. Some even allege that this is the reason big Internet companies such as Amazon are supporting such taxes, seeing them as a means to drive out smaller competition.[143]

The Business Activity Tax Simplification Act of 2015 was introduced in the House partially to address this concern by setting a minimum nexus "threshold."[144] Under the bill, businesses have to surpass a threshold level of activity in a given state before that they can be taxed by that state.[145] The bill is an admirable effort to address the judicially murky issue of how much nexus is sufficient and would effectively shield businesses from having to contend with the myriad taxing rules of various jurisdictions unless the threshold activities level is reached. However, it alone is insufficient to address the increasing challenges states face in capturing the tax revenue from sale or use of digital content and will likely further erode

140. Nat'l Bellas Hess, Inc. v. Dep't of Revenue, 386 U.S. 753, 759–60 (1967) (footnotes omitted).

141. *Id.* at 759 n.13.

142. Quill Corp. v. North Dakota, 504 U.S. 298, 318 (1992) ("This aspect of our decision is made easier by the fact that the underlying issue is not only one that Congress may be better qualified to resolve, but also one that Congress has the ultimate power to resolve. No matter how we evaluate the burdens that use taxes impose on interstate commerce, Congress remains free to disagree with our conclusions.").

143. Matt Brownell, *The Marketplace Fairness Act: Why Amazon Wants to Be Taxed*, DAILY FIN. (Mar. 25, 2013, 2:00 PM), http://www.dailyfinance.com/on/the-marketplace-fairness-act-why-amazon-wants-to-be-taxed/.

144. Business Activity Tax Simplification Act of 2015, H.R. 2584, 114th Cong. (2015).

145. *Id.*

states' tax bases. Moreover, if the minimum threshold is set too low, the bill runs the risk of violating efficiency and fairness concerns by taxing similar content differently.

This Note argues that small businesses can instead be more effectively protected by simplifying the sales tax regime for remote sales with legislation such as the MFA[146] and the Streamlined Sales and Use Tax Agreement (SSUTA).[147]

D. Additional Tax Policy Goals

There are many other tax policy considerations that may impact the decision of whether to tax digital content.

First, one consideration is whether taxing Internet streaming would be regressive or progressive. When Netflix use was taxed in Buenos Aires, the Argentine president argued that the tax would be regressive because cable users have higher capacity to pay.[148] On the other hand one could also argue that higher income taxpayers are generally more likely to have access to Internet services with sufficient capacity to stream high definition content. Admittedly this differentiation is diminishing as technology becomes more readily available and the cost of access decreases. Moreover, as technology's allure increases, partially thanks to the multitude of digital content available, Internet access is no longer limited to the elite and business community.

Another potential justification for offering tax-preferred treatment to digital content is environmental concerns. Studies have found that choosing streaming over physical products significantly lessens carbon dioxide emissions.[149] For example the carbon dioxide emissions associated with purchasing a CD from a retail store are approximately 3200 grams compared to 400 grams for an album purchased and downloaded online.[150]

Last but not least one could argue that the use of digital content promotes Internet access, which is presumably beneficial and

146. The Marketplace Fairness Act, S. 698, 114th Cong. (2015); *see also* discussion of the Marketplace Fairness Act, *infra* Part III.B.2.

147. STREAMLINED SALES AND USE TAX AGREEMENT (2014), *available at* http://www.streamlinedsalestax.org/uploads/downloads/Archive/SSUTA/SSUTA%20as%20Amended%20Through%20October%208,%202014.pdf.

148. *See* Hoke, *supra* note 12 (discussing the constitutionality of the tax).

149. CHRISTOPHER L. WEBER, JONATHAN G. KOOMEY & H. SCOTT MATTHEWS, THE ENERGY AND CLIMATE CHANGE IMPACTS OF DIFFERENT MUSIC DELIVERY METHODS 13 (2009), *available at* http://download.intel.com/pressroom/pdf/cdsvsdownloadsrelease.pdf.

150. *Id.*

should be encouraged by not subjecting it to tax. For example, assuming streaming movies and renting DVDs are close economic substitutes and consumers are price sensitive, not taxing streaming would encourage more consumers to watch movies this way, thus incentivizing them to purchase higher speed Internet services for a high-definition and buffer-free streaming experience. The higher quality Internet access would increase the consumer's productivity when engaging in information access and communications,[151] which may lead to social growth and innovation. On the other hand, one might also argue that most of the benefits of higher speed Internet access—such as greater enjoyment of entertainment services and increased productivity—are internalized by the consumer in the form of increased happiness or salary, which should be reflected in the prices consumers are willing to pay. Therefore, faster Internet access should not be subsidized by the government.

In sum, while there are some reasons not to tax digital content, they are not sufficient to outweigh the countervailing efficiency concerns. The belief that similar products should be taxed similarly is an important ideological principal on which our tax system is built. Moreover eliminating digital content from state and local governments' sales tax base would cause heavy revenue loss, since sales tax constitutes a quarter of state and local governments' revenues.[152] However, proposed legislation should take special care to address the unique technical difficulties of taxing digital commerce and not to overburden small businesses.

III.
HOW TO TAX INTERNET STREAMING

This section briefly surveys the approaches different states have taken to taxing digital products and then examines a pair of proposed federal solutions—the MFA and the DGSTFA. Lastly this Note makes a suggestion on how digital content should be taxed.

151. *See* ROBERT D. ATKINSON & ANDREW MCKAY, DIGITAL PROSPERITY: UNDERSTANDING THE ECONOMIC BENEFITS OF THE INFORMATION TECHNOLOGY REVOLUTION 12 (Information Technology & Innovation Foundation 2007), *available at* http://www.itif.org/files/digital_prosperity.pdf (discussing benefits of the IT revolution, including economic growth, productivity, and more efficient markets).

152. Michael Mazerov, *"Digital Goods and Services Tax Fairness Act" Would Impair Funding for Education, Health Care and Other State and Local Services*, CTR. ON BUDGET & POL'Y PRIORITIES (May 29, 2012), http://www.cbpp.org/cms/index.cfm?fa=view&id=3783.

A. A Survey of States' Approaches

At the state level commodity taxes are generally either imposed through sales or use tax. Upon establishing a nexus to the state, the seller normally has the duty to collect sales tax for the state and is liable for any shortages. The use tax is designed to complement the sales tax. In the event that the state does not have a sufficient nexus to the seller to impose withholding obligations, the buyers would be required to directly pay a use tax. Taken together they should "provide a uniform tax upon either the sale or the use of all tangible personal property irrespective of where it may be purchased."[153] A use tax is comparatively more difficult to administer and to enforce because the consumer bears the responsibility for reporting the purchase and paying the tax liability. Some states, such as California, permit sales taxes paid in other states to offset use tax.[154]

States were initially slow to enact sales tax on digital content because most existing state sales tax laws and regulations focused on tangible property and specific services.[155] The sale of digital content generally involved no transfer of title of tangible property and therefore was not a taxable event. However, as it became increasingly apparent that consumers are replacing traditional products with digital goods, more states sought to impose taxes on digital transactions to close the tax loophole.[156] Nevertheless, the states greatly diverge on how digital content is taxed because of the differences in: (1) definitions of "digital products," (2) tax treatment of particular types of digital products, (3) sourcing rules, and (4) bundling rules.[157] The following sections study the first three components of the tax, but do not focus on the fourth because it is more relevant to cloud computing. After examining the tax laws of the

153. Broadacre Dairies, Inc. v. Evans, 246 S.W.2d 78, 80 (Tenn. 1952).

154. *See, e.g.*, CAL. REV. & TAX CODE § 6406 (West 2015) (providing for tax credits against taxes paid to another jurisdiction).

155. Of the forty-five states with sales taxes, only a few tax digital goods and services as broadly as they tax non-downloaded goods and services. In comparison, "most state sales tax laws say that all types of 'tangible personal property' (physical goods) are subject to sales taxes unless explicitly exempted." Michael Mazerov, *States Should Embrace 21st Century Economy by Extending Sales Taxes to Digital Goods and Services*, at 10–12, CTR. ON BUDGET AND POL'Y PRIORITIES (Dec. 13, 2012), http://www.cbpp.org/sites/default/files/atoms/files/12-13-12sfp.pdf.

156. *See infra* text accompanying notes 179–87.

157. *Taxability of Digital Products*, AVALARA, http://www.avalara.com/learn/whitepapers/identification-taxability-of-digital-products/ (last visited Mar. 31, 2015); States diverge on whether a digital product sold is considered to be a part of a service or should be treated separately for sales tax purposes. *Id.*

various states, this Note discusses the problems with the current patchwork approach.

1. Definition of "Digital Products"

There are three general approaches to defining "digital products."[158] Twelve states[159] have adopted the Streamlined Sales Tax Governing Board's (SST) universal definitions of "specified digital products."[160] Seventeen states[161] define specified digital products

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158. *See id.*

159. *See* IND. CODE §§ 6-2.5-4-16.4, 6-2.5-1-26.5 (2015); KY. REV. STAT. ANN. § 139.010(9)(a) (West 2015); NEB. REV. STAT. § 77-2701.16(9) (2015); NEV. REV. STAT. § 360B.483 (2015); N.J. STAT. ANN. § 54:32B-2(zz) (West 2015); N.D. CENT. CODE § 57-39.2-04(54) (2015); TENN. CODE ANN. § 67-6-102(86) (2015); VT. STAT. ANN. tit. 32, §§ 9771(8), 9773(4) (2015); WIS. STAT. § 77.51(17x) (2015); WYO. STAT. ANN. § 39-15-101(a)(xliii) (2015); 11-25 R.I. CODE R. § 5 (LexisNexis 2011); WASH. ADMIN. CODE § 458-20-15503 (2015).

160. The SSUTA defines "specified digital products" as "electronically transferred:"

> "Digital Audio-Visual Works" which means a series of related images which, when shown in succession, impart an impression of motion, together with any accompanying sounds, if any,
> "Digital Audio Works" which means works that result from the fixation of a series of musical, spoken, or other sounds, including ringtones, and
> "Digital Books" which means works that are generally recognized in the ordinary and usual sense as 'books'.

STREAMLINED SALES AND USE TAX AGREEMENT, *supra* note 147, app. C, pt. II, at 102.

161. *See* ARK. CODE ANN. § 26-52-301(3)(C)(iii) (2015) (defining "Digital Audio-Visual Works" and "Digital Audio Works," but not "Digital Books"); CONN. GEN. STAT. § 12-407(a)(26)(A) (2015) (defining digital products indirectly by excluding "digital products delivered electronically, including, but not limited to, software, music, video, reading materials or ring tones" from "telecommunications services"); GA. CODE ANN. § 48-8-2 (2015) (defining digital products indirectly by excluding "[d]igital products delivered electronically, including, but not limited to, software, music, video, reading materials or ring tones" from "telecommunications services"); ILL. ADMIN. CODE tit. 86, § 130.2105(a)(3) (2015) (defining digital goods as "[i]nformation or data that is downloaded electronically, such as downloaded books, musical recordings, newspapers or magazines"); IOWA ADMIN. CODE r. 701-231.14(423) (2015) (excluding digitally delivered goods from the definition of "taxable" sales); KAN. STAT. ANN. § 79-3602(aaa)(9) (West 2015) (defining "digital products" indirectly by excluding "digital products delivered electronically, including, but not limited to, software, music, video, reading materials or ring tones" from "telecommunications services"); LA. ADMIN. CODE tit. 61, § 4301(C)(Tangible Personal Property)(a)(iv) (2015) (including as tangible personal property "digital or electronic products such as 'canned' computer software, electronic files, and 'on demand' audio and video downloads"); ME. STAT. tit. 36, § 1752(9-E) (2015) (defining "product transferred electronically" as "digital product transferred to the purchaser electronically the sale of which in nondigital physical form would be subject to tax under this Part as a sale of tangible personal property"); MICH. COMP. LAWS §§ 205.92(k), .93, .93c(4)(m)(x), .51a(q),.52(1)

by statute, although some define it more narrowly than others. Some of those states are SST members whose statutory definitions of digital products closely resemble the SST definition. The remaining sixteen states and the District of Columbia[162] do not specifically define digital products for sales tax purposes. However, as will become apparent, the existence or lack of a definition does not necessarily predict the state's decision whether to tax the product.

2. Tax Treatment

States have generally adopted one of three approaches in the tax treatment of digital content. Twelve states[163] specifically define

(2015) (the statutes do not explicitly define "digital products" for sales and use tax purposes, but exclude "digital products delivered electronically, including, but not limited to, software, music, video, reading materials, or ring tones" from "telecommunication services"); MINN. STAT. § 297A.61 subdiv. 50-55 (2015) (defining several categories of "specified digital products"); MISS. CODE. ANN. § 27-65-26 (2015) (specifically defining "specified digital products"); N.C. GEN. STAT. § 105-164.4(a)(6b) (2015) (clarifying that the general sales tax applies to digital property sold at retail and specifically applies to audio, audiovisual, written, and photographic property); OHIO REV. CODE ANN. § 5739.01(QQQ) (LexisNexis 2015) (defining "specified digital products"); OKLA. ADMIN. CODE § 710:65-19-156(b)(6) (2011) (defining it as "[s]ales of digital products delivered electronically including music, video, ringtones, and books"); TEX. TAX CODE ANN. § 151.010 (West 2015); TEX. DOR POLICY LETTER 200005359L; TEX. COMPTROLLER OF PUB. ACCOUNTS, LTR. RUL. 200101966L (Jan. 3, 2001) (not defining digital products by statute, but incorporating them into the broad category of "tangible personal property" via a policy letter); TEX. COMPTROLLER OF PUB. ACCOUNTS, LTR. RUL. 200005359L (May 30, 2000); UTAH CODE ANN. § 59-12-102(35)–(37) (West 2015); W. VA. CODE § 11-15B-2b(b)(1)(B)(v) (2015) (excluding "[d]igital products 'delivered electronically', including, but not limited to, software, music, video, reading materials or ring tones" from "telecommunications services," but not otherwise defining "digital products").

162. The seventeen states include Alabama (ALA. CODE § 40-23-1(a)(6) (2015)), Arizona (ARIZ. REV. STAT. ANN. § 42-5001 (2015)), California (CAL. REV. & TAX. CODE § 6016 (West 2015)), Colorado (COLO. REV. STAT. §§ 39-26-102, -104 (2015)), District of Columbia (D.C. CODE ANN. § 47-2001(n)(2)(G) (West 2015)), Florida (FLA. STAT. § 212.02 (2015)), Hawaii (HAW. REV. STAT. §§ 237-1, -3 (2015)), Idaho (IDAHO CODE ANN. § 63-3609, -3612 (West 2015)), Maryland (MD. CODE ANN. TAX-GEN. § 11-101 (West 2015)), Massachusetts (MASS. GEN. LAWS ANN. ch. 64H, § 1 (West 2015)), Missouri (MO. REV. STAT. §§ 144.010, 144.605 (2015)), New Mexico (N.M. STAT. ANN. §§ 7-9-3, 7-9-3.5 (West 2015)), New York (N.Y. TAX LAW § 1101(b) (McKinney 2015); N.Y. COMP. CODES R. & REGS. tit. 20, § 526.8 (2015)), Pennsylvania (72 PA. CONS. STAT. ANN. § 7201 (West 2015); 61 PA. CODE §§ 31.1, 31.7 (2006)), South Carolina (S.C. CODE ANN. § 12-36-60 (2015)), South Dakota (S.D. CODIFIED LAWS § 10-45-1 (2015)), and Virginia (VA. CODE ANN. §§ 58.1-602, -647) (2015)).

163. *See* IND. CODE § 6-2.5-1-26.5 (2015); MISS. CODE. ANN. § 27-65-26 (2015); 316 NEB. ADMIN. CODE 1-045 (2015); N.J. STAT. ANN. § 54:32B-3 (West 2015); N.C.

digital products in some way and affirmatively impose a tax on their sale either through tax laws or regulations. Fifteen states[164] group

GEN. STAT. § 105-164.4(a)(6b) (2015); OHIO REV. CODE ANN. § 5739.01(QQQ) (West 2015); TENN. CODE ANN. § 67-6-102(86), -233 (2015); UTAH CODE ANN. §§ 59-12-102(35)–(37), 59-12-103(1)(m) (West 2015); VT. STAT. ANN. tit. 32, § 9771(8) (2015); WASH. REV. CODE § 82.04.050 (2015); WIS. STAT. § 77.51(17x) (2015); 11-2 WYO. CODE R. § 13(ff) (LexisNexis 2015).

164. These fifteen states include Alabama (ALA. CODE § 40-12-220(8) (2015); ALA. ADMIN. CODE § 810-6-1-.119 (2015); Robert Smith d/b/a FlipFlopFoto v. Dep't of Revenue, No. S. 05-1240, 2006 WL 3587184, at *5 (Ala. Admin. Law Div. Nov. 17, 2006) (holding that sales of digital images transmitted electronically were subject to sales tax because the digital images constituted tangible personal property.)), Arizona (ARIZ. REV. STAT. ANN. § 42-5008, -5155 (2015)), Arkansas (ARK. CODE ANN. § 26-52-301 (2015)), Colorado (COLO. REV. STAT. § 39-26-104(1)(a) (2015) (subjecting sales and purchases of tangible personal property to tax); COLO. DEP'T OF REVENUE GEN. INFO. LTR., GIL-13-020 (Aug. 20, 2013) (subjecting electronically delivered magazines to tax); COLO. DEPT. OF REVENUE GEN. INFO. LTR., GIL-11-014 (July 29, 2011) (subjecting electronically delivered newspapers, music, movies and books to tax)), Connecticut (DEP'T OF REVENUE SERVICES, STATE OF CONN., SALES AND USE TAXES ON COMPUTER-RELATED SERVICES AND SALES OF TANGIBLE PERSONAL PROPERTY, PS 2006(8), *available at* http://www.ct.gov/drs/lib/drs/publications/pubsps/2006/ps06-8.pdf; *Are Sales or Purchases of "Digital Downloads" from the Internet Subject to Connecticut Sales or Use Tax?*, STATE OF CONN. DEP'T OF REVENUE SERVICES, TAXPAYER ANSWER CENTER, https://askdrs.ct.gov/Scripts/drsrightnow.cfg/php.exe/enduser/std_adp.php?p_faqid=750 (last visited May 16, 2015), Florida (FLA. STAT. ANN. § 212.05 (West 2015); FLA. DEP'T OF REVENUE, TECHNICAL ASSISTANCE ADVISEMENT, TAA 14A19-006 (Dec. 19, 2014), *available at* https://revenuelaw.state.fl.us/LawLibraryDocuments/2014/12/TAA-119174_14A19-006%20REDACTED%20_%20SUMMARY.pdf; FLA. DEP'T OF REVENUE, TECHNICAL ASSISTANCE ADVISEMENT, TAA 14A19-005 (Dec. 18, 2014), *available at* https://revenuelaw.state.fl.us/LawLibraryDocuments/2014/12/TAA-119162_14A19-005%20REDACTED%20_%20SUMMARY.pdf;), Hawaii (HAW. CODE. R. § 18-237-1 (LexisNexis 2015)), Idaho (IDAHO CODE §§ 63-3616, -3619, -3621 (2015); IDAHO ADMIN. CODE r. 35.01.02.027 (2015) (defining "canned software" as subject to tax)), Illinois (ILL. ADMIN. CODE tit. 86, §§ 130.1935(a), 130.2105(a)(3) (2015) (information or data downloaded electronically, with the exception of downloaded canned software, do not constitute the transfer of tangible personal property, and thus are not subject to tax), Kentucky (KY. REV. STAT. ANN. § 139.200(1) (West 2015)), Louisiana (LA. ADMIN. CODE tit. 61, § 4302 (2015)), Maine (ME. STAT. tit. 36, §§ 1752 & 1811 (2015); SALES, FUEL & SPECIAL TAX DIV., ME. REVENUE SERVS., INSTRUCTIONAL BULLETIN NO. 56 (June 12, 2009), *available at* https://www1.maine.gov/revenue/salesuse/Bull5609202013.pdf; SALES, FUEL & SPECIAL TAX DIV., ME. REVENUE SERVS., INSTRUCTIONAL BULLETIN NO. 3, (July 28, 2008), *available at* https://www1.maine.gov/revenue/salesuse/Bull308.pdf (taxing sales of digital photographs delivered electronically, in the same manner as hard-copy photographs)), Minnesota (MINN. STAT. ANN. § 297A.61 Subdivs. 3(l), 4(o), 10(b)(5), 50 (West 2015); MINN. STAT. ANN. §§ 297A.62–297A.63 (West 2015)), New Mexico (N.M. STAT. ANN. §§ 7-9-4,-7 (West 2015); N.M. TAXATION & REVENUE DEP'T RULING 401-97-6 (Nov. 20, 1997) (New Mexico generally taxes all gross receipts from the sales of tangible personal prop-

Internet streaming and digital products into an existing taxable category, either through revision of the tax codes or regulations. Such states may tax digital products as transfers of tangible personal property, services, or a mixed transaction.[165]

Even within this category states' approaches vary widely. For example Florida subjects streaming services to the telecommunications services tax.[166] Texas taxes it as broadly defined cable television services.[167] Arizona's tax on streaming services mirrors the tax on its physical counterpart.[168]

The remaining eighteen states and the District of Columbia[169] either do not affirmatively impose sales tax on digital content or

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erty and services including digital products.)), South Dakota (S.D. CODIFIED LAWS § 10-45-2.4. (2015) (imposing a tax on "products transferred electronically" at the same rate imposed upon sales of tangible personal property if the sale is to an end user)), and Texas (TEX. TAX CODE ANN. § 151.010 (West 2015); TEX. COMPTROLLER OF PUB. ACCOUNTS, LTR. RUL. 200101966L (Jan. 3, 2001); TEX. COMPTROLLER OF PUB. ACCOUNTS, LTR. RUL. 200005359L (May 30, 2000)).

165. The categorization is important because most states tax all sales of tangible personal property but only specifically enumerated services.

166. FLA. DEP'T OF REVENUE, GT-800011, COMMUNICATIONS SERVICES TAX 1 (2014), *available at* http://dor.myflorida.com/Forms_library/current/gt800011.pdf.

167. TEX. COMPTROLLER OF PUB. ACCOUNTS, LTR. RUL. 200005359L (May 30, 2000).

168. ARIZ. REV. STAT. ANN. § 42-5001 (2014). (taxing fees paid to stream videos as if they were rental fees of tangible personal property).

169. These eighteen states include California (CAL. BD. OF EQUALIZATION, INFORMATIONAL PUB. 109, INTERNET SALES (2014), *available at* https://www.boe.ca.gov/formspubs/pub109/), Georgia (GA. CODE ANN. § 48-8-30 (2014); *Georgia State Taxability Matrix*, STREAMLINED SALES TAX GOVERNING BD. (Aug. 10, 2015, 1:21 PM), http://www.streamlinedsalestax.org/otm/ (follow "Georgia" hyperlink)), Illinois (ILL. ADMIN. CODE tit. 86, § 130.2105 (2015)), Iowa (IOWA ADMIN. CODE r. 701-18.61 (422,423) (2015)), Kansas (KANSAS DEP'T OR REVENUE POLICY & RESEARCH, EDU-71R, INFORMATION GUIDE: REVISED SALES TAX GUIDELINES: TAXING CHARGES FOR COMPUTER PRODUCTS AND SERVICES AND INTERNET RELATED SALES AND SERVICES (2010), *available at* http://rvpolicy.kdor.ks.gov/Pilots/Ntrntpil/IPILv1x0.NSF/ae2ee39f7748055f8625655b004e9335/d027d08cc9b549c0862577690069a459?OpenDocument), Maryland (MD. CODE ANN. TAX-GEN. § 11-102 (West 2015)), Massachusetts (MASS. GEN. LAW ANN. ch 64H § 2, ch. 64I § 2 (West 2015); MASS. DEP'T OF REVENUE TECHNICAL INFO. RELEASE 05-8, § VII.B.8 (Jul. 14, 2005), *available at* http://www.mass.gov/dor/businesses/help-and-resources/legal-library/tirs/tirs-by-years/2005-releases/tir-05-8-taxation-of-internet-access.html), Michigan (MICH. COMP. LAWS ANN. § 205.92(k), 205.93, 205.93c, 205.51a(q) & 205.52(1) (West 2015) (excluding it from sales and use tax); *Michigan State Taxability Matrix*, STREAMLINED SALES TAX GOVERNING BD. (Aug. 24, 2015, 2:19 PM), http://www.streamlinedsalestax.org/otm/ (follow "Michigan" hyperlink)), Missouri (MO. ANN. STAT. §§ 144.020, 144.610 (West 2015); MO. DEP'T OF REVENUE LTR. RUL. 3923 (July 19, 2007) (concluding that "the sale or rental of streaming video con-

expressly exempt it from taxation. The decision not to tax digital products is often based on an artificial distinction between tangible and intangible products that may lead to arbitrary results. For example California does not tax streaming because the state law only taxes "tangible" property and digital products are deemed intangible.[170] Louisiana taxes downloaded software because customers receive property rights but does not tax video-on-demand and pay-per-view services because the customer receives limited viewing rights and no recording or downloading occurs.[171] A Missouri De-

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tent is not subject to sales or use tax")), Nevada (*Sales Tax Information & FAQ's*, NEV. DEP'T OF TAXATION, http://tax.nv.gov/FAQs/Sales_Tax_Information___FAQ_s/ (last visited May 16, 2015)), North Dakota (N.D. CENT. CODE § 57-39.2-04(54) (2015)), New York (N.Y. TAX LAW §§ 1105, 1110 (McKinney 2015); N.Y. STATE DEP'T OF TAXATION & FIN. ADVISORY OPS. TSB-A-10(27)S (June 29, 2010) (concluding that movies rented by a movie theatre and delivered electronically were not taxable because they are intangible), TSB- M-11(5)S (Apr. 7, 2011) (certain e-books are not taxable), TSB-A-11(20)S (July 8, 2011) (e-books are not taxable), TSB-A-99(48)S (Nov. 12, 1999) (transfer of digital photography is not taxable), TSB-A-01(15)S (Apr. 18, 20-1) (transfer of digital music is not taxed), TSB-A-08(22)S (May 2, 2008) (transfer of digital video is not taxable) & TSB-A-07(14)S (May 17, 2007) (sale of codes and digital music is not subject to tax)), Oklahoma (OKLA. ADMIN. CODE § 710:65-19-156(b)(5) (2015)), Pennsylvania (72 PA. CONS. STAT. ANN. § 7202 (West 2015) (not affirmatively imposing tax on digital content); 61 PA. CODE §§ 31.1, 31.7 (2015)), Rhode Island (*Rhode Island State Taxability Matrix*, STREAMLINED SALES TAX GOVERNING BD. (July 31, 2015, 10:41 AM), http://www.streamlinedsalestax.org/otm/ (follow "Rhode Island" hyperlink)), South Carolina (S.C. CODE ANN. §§ 12-36-60, -110, -910, -1310, -1330 (2015) (not affirmatively imposing tax on digital products)), Virginia (VA. CODE ANN. §§ 58.1-603, -604, -648(C) (2015) (exempting "digital products delivered electronically" from tax)), and West Virginia (*West Virginia State Taxability Matrix*, STREAMLINED SALES TAX GOVERNING BD. (Aug. 13, 2015, 11:30 AM), http://www.streamlinedsalestax.org/otm/ (follow "West Virginia" hyperlink)). The District of Columbia also fits in this category. *See* D.C. Code § 47-2002 (2015).

170. CAL. BD. OF EQUALIZATION, INFORMATIONAL PUB. 109, INTERNET SALES (2014), *available at* https://www.boe.ca.gov/formspubs/pub109/.

171. *See* 61 LA ADC Pt I, § 4301(a)(iv) (2014). However, this law is subject to change. Louisiana's Department of Revenue asserted that transactions involving pay-per-view and on-demand movies are taxable in DEP'T OF REVENUE, STATE OF LA., RIB 10-015, SALES TAX TREATMENT OF TRANSACTIONS INVOLVING PAY-PER-VIEW AND ON-DEMAND MOVIES LEASED BY VIEWERS FROM CABLE TELEVISION AND SATELLITE TELEVISION PROVIDERS (2010), *available at* http://www.revenue.louisiana.gov/Laws Policies/RIB10-015.OnDemandPPVMovies.6-25-10.pdf, but withdrew its position in 2011. DEP'T OF REVENUE, STATE OF LA., RIB 10-028, TEMPORARY SUSPENSION OF POLICY STATEMENTS PERTAINING TO DIGITAL TRANSACTIONS (2010) (temporarily suspending RIB 10-015); DEP'T OF REVENUE, STATE OF LA., RIB 11-009, POLICY STATEMENT PERTAINING TO PAY-PER-VIEW AND VIDEO ON-DEMAND MOVIES REPEALED (2011) (repealing RIB 10-015); *see also Louisiana Uniform Tax Matrix*, TRANSACTION TAX RESOURCES (Oct. 20, 2015), https://www.ttrus.com/utm/louisiana-utm.pdf (summarizing the taxability of various items in Louisiana).

partment of Revenue letter ruling held that streaming video is not taxable because customers do not receive tangible property.[172] Missouri subsequently adopted a rule specifying that digital products are only subject to tax if the purchaser was offered the right to use "specifically identified tangible personal property."[173]

Sometimes whether the consumer is subject to a sales tax depends on the form of the product the consumer chooses. Oklahoma does not tax sales of digital music[174] or online gaming memberships and point cards[175] when no tangible personal property is sold. Similarly photography and videography services are not taxable when the end product is delivered electronically rather than physically.[176] In New York e-books are exempt from sales tax.[177] However, a product is only deemed an "e-book"—and thus tax-exempt—when it meets five specifically defined conditions, such as being provided as a single download and not being updated more frequently than annually.[178]

Recently more states are expanding their sales tax base to include digital products as a sale of an intangible product or service. In the past three years, Maine enacted its 2014-15 budget[179] which legislatively adopted its Department of Revenue's position that digital products are taxable if their physical counterparts are otherwise taxable.[180] The New York State Tax Reform and Fairness Commission proposed extending sales tax to e-books, video-on-demand, and music.[181] Ohio also passed a budget bill[182] to include digital products as services subject to sales tax.[183] Minnesota passed the

172. MO. LTR. RUL. 7338 (Dec. 20, 2013).

173. MO. CODE REGS. ANN. tit. 12 § 10-109.050 (2015).

174. OKLA. TAX COMM'N LTR. RUL. 13-023 (Aug. 1, 2013).

175. OKLA. TAX COMM'N LTR. RUL. 13-033 (Sept. 16, 2014).

176. OKLA. TAX COMM'N PRIV. LTR. RUL. 13-013 (July 11, 2013).

177. N.Y. STATE DEP'T OF TAXATION & FIN. TECHNICAL MEMORANDUM TSB-M-11(5)(S) (April 7, 2011).

178. *Id.*

179. L.D. 1509, 126th Gen. Assemb., reg. Sess. (Me. 2013).

180. However, the issue is still debated because L.D. 1572, the technical corrections bill that clarifies the budget, was vetoed by the governor. L.D. 1572, 126th Gen. Assemb., reg. Sess. (Me. 2013); *see also*, STATE OF MAINE OFFICE OF THE GOVERNOR, LD 1572 VETO MESSAGE, (Jan. 10, 2014), *available at* http://content.govdelivery.com/attachments/MEGOV/2014/01/10/file_attachments/262464/LD%2B1572%2BVeto%2BMessage.pdf (letter from Maine Governor LePage to the legislature explaining his decision to veto LD 1572).

181. Fottrell, *supra* note 114.

182. H.B. 59, 130th Sess. (Ohio 2013).

183. Maggie Thurber, *Hurry, Shoppers! Ohio's Sales Tax Increase is Days Away*, OHIO WATCHDOG (August, 22, 2013), http://watchdog.org/102341/ohios-sales-tax-is-going-up/.

Tax Omnibus Bill, expanding its sales tax to cover digital products,[184] as did Washington, Kentucky, Vermont, and Wisconsin.[185] Florida broadened its definition of services under the Florida Communications Services Tax by replacing the words "cable service" with "video service."[186] In addition, some states that already tax some forms of digital products are moving to tax them more fully. For example, Connecticut considered a proposal to impose the full sales tax rate on digital products.[187]

3. Sourcing of Digital Products

SST has five sourcing rules for digital products.[188] They are based on (1) the business location of seller, (2) the receipt location by purchaser, (3) the purchaser's address that is available from the business records, (4) the purchaser's address obtained during the consummation of the sale, and (5) the address from which the digital good or service was delivered or provided electronically.[189] However, as discussed earlier, there are still many ambiguities with sourcing digital products.[190] The concepts of destination and benefit are not easily applied to digital items. Moreover, it may be difficult for sellers to know where the product is actually received or used. Sometimes even the purchaser may not know the exact location where the product is being "used," particularly if the purchaser then redistributes the product or if it is used in multiple locations.

States have developed varying definitions to address those ambiguities. Alabama, New Mexico, North Dakota, and Rhode Island define the place of use as server location.[191] States that define digital products as tangible personal property generally source by desti-

184. H.F. 677, 2013 Leg., 88th Sess. (Minn. 2013).

185. *See* Fottrell, *supra* note 114.

186. Fla. Stat. Ann. § 202.11 (West 2015).

187. H.B. 6704, 2011 Leg., Jan. Sess. (Conn. 2013). The proposal was later rejected. Jamison Bazinet, *State Budget Update* (June 4, 2013), http://cthousegop.com/2013/06/state-budget-update-2/.

188. STREAMLINED SALES AND USE TAX AGREEMENT, *supra* note 147, § 310A.

189. *Id.*

190. *See supra* Part II.B (discussing, for example, the technical difficulties of determining the destination of a buyer).

191. *See* 21 BUREAU OF NAT'L AFFAIRS, TAX MANAGEMENT MULTISTATE TAX REPORT S-23 (2014) (while most states now source according to user location, others such as New Mexico, North Dakota and Rhode Island source by server location); Eric Tresh & David Pope, *State Taxation of Digital Goods and Electronic Commerce*, at 14 (2012), http://www.stateandlocaltax.com/State%20Taxation%20of%20Digital%20Goods%20and%20E-Commerce.pdf (stating that Alabama defines place of use as server location).

nation.[192] New York and an increasing number of states define the place of use as the user location.[193] Pennsylvania recently reversed its former position that the server's location is paramount in determining whether PA tax applies;[194] instead taxability is determined by user location.[195] Massachusetts sources software based on multiple points of use.[196] Colorado adopted a similar approach in 2010, but the measure was controversial and later repealed.[197]

The issue becomes more complicated when the digital content is used in multiple states. Many states resolve the issue through allocation or apportionment of the sales tax base.[198] While this is a permissive election in some states, other states require it.[199] State statutes and regulations often do not provide one clear solution, but rather a range of acceptable answers.[200] For example Washington allows the taxpayer a choice of determining the taxable amount using either the pro forma numbers or by approximation, calculated by comparing the number of users in the state with the number of users elsewhere.[201] In such cases most auditors will look to the facts to determine a sensible approach.[202]

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192. June Summers Haas & Curtis Osterloh, *COST 45th Ann. Meeting: Cloud Computing, Digital Products, and SALT* (Oct. 15, 2014), http://files.eventsential.org/c0a1149b-399a-4b42-9431-7604e3e7ec07/event-276/56399628-Cloud%20Computing%20Digital%20Products%20and%20the%20Impact.pdf.

193. *See id.*, at 11 (New York, Alabama and other states are trending towards defining place of use as user location).

194. PA. SALES AND USE TAX RUL., NO. SUT-10-005 (Nov. 18, 2010); *see also* Jennifer Jensen & Alesia Parfiryeva, *Taxation of the Cloud Still Hazy* (June 1, 2013), http://www.thetaxadviser.com/issues/2013/jun/salt-june2013.html#fnref_4 (reporting that the prior revenue ruling was rescinded).

195. PA. SALES AND USE TAX RUL., NO. SUT-12-001 (May 31, 2012).

196. MASS. DEP'T OF REVENUE, TECHNICAL INFO. RELEASE, TIR 05-15 (Feb. 10, 2006), *available at* http://www.mass.gov/dor/businesses/help-and-resources/legal-library/tirs/tirs-by-years/2005-releases/tir-05-15-transfers-of-prewritten-computer.html.

197. COLO. CODE REGS. § 39-26-102.13 (2015); H.B. 11-1293, 68th Gen. Assemb., 1st Sess. (Colo. 2011) (repealing the revenue regulation without issuing further clarification).

198. *See* Stephen P. Kranz, *Recent Developments in the Taxation of Digital Products and the Cloud*, at 15 (Sept. 26, 2013), http://www.azdor.gov/LinkClick.aspx?fileticket=2CJ7aqUjy24%3D&tabid=74.

199. *Id.*

200. *Id.*

201. WASH. DEP'T OF REVENUE, FORM REV. 27 0050 (Aug. 7, 2013), *available at* http://dor.wa.gov/Docs/forms/ExcsTx/ExmptFrm/DigitalProductsExemptCert.pdf.

202. *See* Kranz, *supra* note 198, at 15.

4. Problems with a State-by-State Solution

The mismatch among states often leads to inconsistent results. The same transaction may be taxed multiple times or not at all depending on which states it originates from and ends in. For example imagine a taxpayer with a Colorado billing address is at Dulles Airport and uses her Wi-Fi to download three movies from the Apple Store whose server is located in Texas.[203] The interaction between the different states' laws may cause the transaction to be taxed three times by Colorado, Texas, and Virginia. This unjustifiable result is not only intuitively unfair but also raises Due Process Clause concerns.

The inconsistent structure may negatively affect interstate commerce by increasing compliance costs for companies doing businesses in multiple states, which may become crippling for smaller companies. Companies may also prefer customers in certain states with more favorable tax treatments or clearer rules, potentially resulting in disparate treatment of customers from different states. The burdens on interstate commerce and potentially discriminatory results may raise issues under the Commerce Clause.

Lastly the inconsistent tax framework may also impact international commerce. Foreign companies may be unwilling to venture into the disjointed state tax system, fearing that the same income may be taxed twice or thrice by different states, and consequently become reluctant to enter into digital transactions with U.S. parties.[204] The Supreme Court interpreted the Foreign Commerce Clause[205] to prohibit such a result in *Japan Line v. County of Los Angeles*, holding that state and local taxes must not prevent the federal government from "speaking with one voice" when regulating foreign relations.[206]

These concerns have in part led to various proposals seeking to unify and simplify the tax system. Forty-four states and many businesses and local governments have joined together to develop the SSUTA over the last eleven years, which was intended to serve as a

203. *See* Tresh & Pope, *supra* note 191, at 13.

204. *See* Colangelo, *supra* note 22, at 968 (explaining that the Supreme Court in *Japan Line* argued that a consideration for "gauging state tax of foreign commerce differently was the need to avoid multiple taxation").

205. U.S. CONST. art. I, § 8, cl. 3.

206. Japan Line, Ltd. v. Cnty. of L.A., 441 U.S. 434, 451 (1979).

platform for reaching an agreement among the states.[207] Congress also proposed legislation such as the MFA and the DGSTFA.[208]

B. A Federal Solution

Although sales and use taxes are traditionally imposed by the states, subject to limitations by the federal government, this Note argues that there is a need for a federal solution or at least uniform agreement among the states for taxing the sales of digital content. This section makes the argument that a uniform solution is necessary and examines the two major proposed federal solutions: the MFA, which references SSUTA;[209] and the DGSTFA.[210]

1. Why a Federal Solution Is Necessary

To resolve the problems caused by the mismatched sales tax regimes among the various states, there needs to be a uniform agreement among states. While the states may reach an agreement among themselves, such a resolution does not appear to be imminent. States have worked on the multi-state compact SSUTA for fifteen years.[211] While forty-four states joined in the movement, only twenty-four states have adopted the resulting resolution.[212] The effort has been stymied by collective action problems and the refusal of large taxing jurisdictions—such as Texas, California, and New

207. *See* Streamlined Sales Tax Governing Board, *What is the Streamlined Sales and Use Tax Agreement?*, http://www.streamlinedsalestax.org/index.php?page=gen_1 (last visited May 16, 2015); *What is the Marketplace Fairness Act of 2013?*, MARKETPLACEFAIRNESS.ORG, http://marketplacefairness.org/what-is-the-marketplace-fairness-act/ (last visited May 16, 2015).

208. *See infra* Part III.B.2–3.

209. STREAMLINED SALES AND USE TAX AGREEMENT, *supra* note 147. The SSUTA, which is intended to serve as a platform for reaching an agreement among the states, was approved by forty-four states and the District of Columbia in November 2002. By now twenty-four states and the District of Columbia, comprising 33% of the country's population, have passed SSUTA legislation, and legislation is pending in at least ten other states. Streamlined Sales Tax Governing Board, *How Many States Have Passed Legislation Conforming to the Agreement?*, http://www.streamlinedsalestax.org/index.php?page=gen_3 (last visited May 16, 2015).

210. H.R. 3724. This Note will not address the recently introduced Business Activity Tax Simplification Act of 2015 in detail because it only sets a "nexus threshold" and does not present a comprehensive framework for future taxation of digital content. H.R. 2584, 114th Cong. (2015).

211. *The Streamlined Sales and Use Tax Agreement*, TAXCLOUD, https://taxcloud.net/sales-tax-resources/about_ssuta.pdf (last visited May 16, 2015) (noting that the Streamlined Sales Tax Governing Board was formed in 2000).

212. Streamlined Sales Tax Governing Board, *About Us*, http://www.streamlinedsalestax.org/index.php?page=about-Us (last visited May 16, 2015) [hereinafter *About Us, SSTGB*].

York—to participate. States do not have the luxury of leisurely waiting for a resolution because digital products are a fast growing industry and the answer to how to tax them has far-reaching consequences ranging from states' revenue to international relations. Therefore, it is in the states' best interests to resolve the issue quickly.

Furthermore, because of the intangible nature of digital content, its taxation impacts out-of-state sellers more heavily than most other sales taxes. While the out-of-state sellers are not *technically* bearing the burden of the sales tax, imposing an obligation to withhold means they would be *economically* sharing the tax burden with customers as well as bearing compliance costs. While bigger companies arguably have more ability to negotiate with states, smaller companies may not be equally well represented in the taxing state's legislative process.[213] Due to the out-of-state parties' lack of political power within the taxing jurisdiction, there is a looming threat that the states may unfairly shift tax burdens onto those unrepresented parties.[214] Additionally the current uncertainty in state tax laws may have a chilling effect on commerce, with businesses uncertain of whether to withhold taxes from customers and how much the tax will affect their revenue. Under-withholding typically subjects sellers to liability for the shortage, while over-withholding could result in consumer class actions.[215]

213. *See generally* Zephyr Teachout & Lina Khan, *Market Structure and Political Law: A Taxonomy of Power*, 91 DUKE J. CONST. LAW & PUB. POL'Y 37, 40 ("A company's political power is at its apex when it is both large in terms of the economy and plays a dominant role in its own markets.").

214. While in-state buyers who are represented in the states' political systems share similar interests with the sellers, their interests are not exactly aligned. For instance in-state buyers may object to excessive sales tax rates but would not mind burdensome withholding procedures imposed on the sellers. *See, e.g.*, Hunt v. Wash. State Apple Adver. Comm'n, 432 U.S. 333, 350–51 (1977) (striking down a North Carolina law where out-of-state apple producers were discriminated against in the legislative process despite having in-state buyers); Granholm v. Heald, 544 U.S. 460, 518–19 (2005) (finding that "[m]any States had laws that discriminated against out-of-state products in addition to out-of-state wholesalers and retailers," and citing a study that found "eight States taxed out-of-state liquor products at greater rates than in-state products" (citation omitted)).

215. Seth L. Cooper, *Digital Downloads Should be Protected from Discriminatory and Duplicative Taxes*, PERSP. FROM FSF SCHOLARS, June 6, 2012, at 2, *available at* http://www.freestatefoundation.org/images/Digital_Downloads_Should_Be_Protected_From_Discriminatory_and_Duplicate_Taxes_060112.pdf ("When state tax departments decide that businesses failed to collect taxes on transactions, claims for back taxes and penalties quickly follow. And when businesses facing uncertainty decide to collect taxes from consumers that state tax officials later determine

Last but not least some companies may take advantage of the ambiguities in the current sourcing rules by negotiating sales tax rebate deals with states and localities. For instance bigger companies like Apple, Amazon, and Netflix have agreed to source the sales tax to a particular state or city in exchange for the state or city returning a percentage of the proceeds to the company.[216] Such deals are not only unfair to smaller companies that do not have the same bargaining power,[217] but also damaging to the state and local governments, which may be forced into a race-to-the-bottom bid for tax revenue. The state and local governments ultimately "winning" the bid may suffer from "winners' curse," while the "losing" governments are cheated out of their already accrued but uncollectable revenue. Moreover, because of the portable nature of the digital products, states' taxation regimes may carry spillover effects causing negative externality costs for other states. For example, consumers can evade taxes by purchasing digital products from a state with lower tax rates causing other states to lose revenue. Because of their intangible nature, this can be more easily done with digital products than with physical products.

Under such circumstances, the federal government is in the best position to resolve the mismatch speedily and effectively, either through legislation directly imposing a simplified system or incentivizing states' adoption of the SSUTA. Because all states are represented in Congress's decision-making, the federal government is more likely to arrive at a balanced solution than state governments acting individually. Additionally, the federal government arguably is more capable of developing a more effective solution by virtue of having access to more resources and expertise than most state governments.

2. Marketplace Fairness Act

Congress has long been concerned with maintaining the delicate balance of honoring states' sovereignty by allowing them to set their own tax policies and limiting state tax powers to avoid exces-

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to be unnecessary, consumer class-action lawsuits with double or treble damage awards and attorney fees can result.").

216. Chris O'Brien, *Tax Rebate Deals with Apple, Amazon and Netflix are Bad News for Communities,* SAN JOSE MERCURY NEWS (June 19, 2012, 4:53 PM), http://www.mercurynews.com/ci_20893423/obrien-tax-rebate-deals-apple-amazon-netflix-bad-communities (providing some examples of the tax rebate deals).

217. For example Cupertino's director of administration, who has offered deals to bigger companies like Apple, admitted that the city has discouraged other companies from requesting them, allegedly saying, "No, thank you." *Id.*

sively harming the free flow of national commerce.[218] With various predecessors,[219] the MFA also attempts to address this concern. If passed, the bill would grant states taxing authority to require remote sellers to withhold sales tax, conditioned upon states' simplifying their taxing regime on products purchased from remote sellers.[220]

Congress's authority for promulgating the legislation is grounded in the Commerce Clause. However, it is unclear whether the Act can withstand scrutiny under the Due Process Clause. While some have interpreted the Supreme Court to have invited congressional action in *Quill*, it is uncertain whether it is a mere concession to Congress's powers under the Commerce Clause.[221] On the other hand, even if one can successfully challenge the MFA under the Due Process Clause, the impact may be limited.[222] Such challenges are most likely to be initiated by taxpayers resisting revenue departments' assessments. In the interest of lowering the production bur-

218. *E.g.*, 4 U.S.C. § 111(a)(2012) (preempting discriminatory state taxation of federal employees); 4 U.S.C. § 113 (2012) (preempting state taxation of nonresident members of Congress); 4 U.S.C. § 114 (2012) (preempting discriminatory state taxation of nonresident pensions); 7 U.S.C. § 2013(a) (2012) (preempting state taxation of food stamps); 12 U.S.C. § 531 (2012) (preempting state taxation of Federal Reserve banks, other than real estate taxes); 15 U.S.C. § 381 (2012) (preempting state and local income taxes on a business if the business's in-state activity is limited to soliciting sales of tangible personal property, with orders accepted outside the state and goods shipped into the state); 15 U.S.C. § 391 (2012) (preempting discriminatory state taxes on electricity generation or transmission); 31 U.S.C. § 3124 (preempting state taxation of federal debt obligations); 43 U.S.C. § 1333(a)(2)(A) (2012) (preempting state taxation of the outer Continental Shelf); 47 U.S.C. § 152 (2012) (preempting local but not state taxation of satellite telecommunications services); 49 U.S.C. § 40116(b) (2012) (preempting state taxation of interstate air carriers, flight passengers, and air transportation tickets); 49 U.S.C. § 40116(c) (2012) (preempting state taxation of flights unless they take off or land in the state); 49 U.S.C. § 40116(f)(2)(a) (2012) (preempting state taxation of nonresident airline employees); *see also* Joseph Henchman, *The Proper Role of Congress in State Taxation: Ensuring the Interstate Reach of State Taxes Does Not Harm the National Economy*, TAX FOUNDATION (Feb. 26, 2014), http://taxfoundation.org/article/proper-role-congress-state-taxation-ensuring-interstate-reach-state-taxes-does-not-harm-national.

219. *See* Main Street Fairness Act, H.R. 5660, 111th Cong. (2010).

220. *What is the Marketplace Fairness Act of 2013, supra* note 207.

221. *See, e.g.*, Richard D. Pomp & Michael J. McIntyre, *State Taxation of Mail-Order Sales of Computers After Quill: An Evaluation of MTC Bulletin 95-1*, 11 ST. TAX NOTES 177, 177 (1996).

222. *Fate of the Marketplace Fairness Act Remains Uncertain as Sales Tax Laws Lag Behind Modern Business Practices*, ST. TAX ADVISORY BD. ROUNDTABLE (Bloomberg BNA), Sept. 27, 2013, at S-21, *available at* http://taxandaccounting.bna.com/btac/core_adp/get_object/Roundtable-Special-Report-2013.pdf.

den and increasing the chances of winning, those taxpayers would likely argue that the law is unconstitutional "as applied."[223] Thus, instead of striking down the entire Act, a court would likely only rule in favor of a taxpayer on an "as applied" basis.

Assuming the bill can pass constitutional muster, it is estimated to generate twenty-three billion dollars.[224] While the revenue will be very attractive to state governments, states are required to simplify their sales tax laws in exchange.[225] This requirement is due to the concerns cited in *Bellas Hess* and *Quill* that having to collect sales taxes for multiple states would be overly burdensome for sellers with no physical presence.[226] Under the current proposal states have two options—joining the SSUTA or meeting five simplification mandates.[227]

The MFA provides that any state that is in compliance with the SSUTA and has achieved Full Member status as a SSUTA implementing state will have collection authority on the first day of the calendar quarter that is at least ninety days after enactment.[228] The goal of the SSUTA is similar to the MFA—to "simplify and modernize sales and use tax administration in order to substantially reduce the burden of tax compliance."[229] Member states are required to adopt uniform tax definitions, uniform and simpler exemption administration, rate simplification, state-level administration of all sales taxes, and uniform sourcing to determine where the sale is taxable.[230] Twenty-four states, representing over 33% of the population, have joined the Agreement thus far, while several other states seem to be considering joining.[231] However, the SSUTA's effectiveness is stymied by the refusal of many large taxing jurisdictions to participate. In response, the SST Governing Board has increasingly focused on attracting more members rather than uniformity and

223. *Id.*

224. Bernie Becker, *Congress to Push Internet Sales Tax after Midterm Elections*, THE HILL (Sept. 23, 2014, 6:00 AM), http://thehill.com/policy/finance/domestic-taxes/218576-congress-to-push-internet-sales-tax-after-midterms.

225. *What is the Marketplace Fairness Act of 2013?*, *supra* note 207 (stressing that the MFA's general framework requires that states simplify their tax laws).

226. *See* constitutional discussion *supra* Part II.

227. Marketplace Fairness Act of 2013, S.R. 743, 113th Cong. §§ 2(a)–(b) (2013).

228. *Id.*

229. *About Us, SSTGB*, *supra* note 212.

230. Streamlined Sales Tax Governing Board, *Frequently Asked Questions*, http://www.streamlinedsalestax.org/index.php?page=faqs (last visited May 16, 2015).

231. *How Many States Have Passed Legislation Conforming to the Agreement?*, *supra* note 209.

simplification. The project has received criticism in the past for permitting separate tax rates for certain goods and not addressing growing local tax jurisdiction complexity.[232]

Alternatively, the MFA also grants states taxing power if they meet five essential simplification mandates.[233] The simplification requirements include, among other things, establishing one central place to file and remit the taxes, setting forth a uniform set of product definitions for what is taxable, adopting a set of uniform sourcing rules,[234] and providing free software to help remote sellers calculate the taxes and file the returns.[235]

232. *See* Joseph Henchman, *The Marketplace Fairness Act: A Primer*, TAX FOUNDATION (July 14, 2014), http://taxfoundation.org/article/marketplace-fairness-act-primer#_ftnref50. *Hearing on H.B. 337 Before the Md. H. Comm. On Ways and Means*, 2009 Leg., 426th Sess. (Feb. 18, 2009), *available at* http://taxfoundation.org/article/testimony-maryland-legislature-streamlined-sales-tax-project (highlighting that the SSTP is "giving up" on increasing sales tax simplicity and that the SSTP's decision to distinguish between "destination sourcing" for online sales and "origin sourcing" for brick and mortar sales prevents a level economic playing field, thereby increasing complexity and artificially distinguishing between goods); John Buhl, *Governing Board Gives Initial Approval to Clothing Threshold*, 50 ST. TAX NOTES 687, 687 (2008) (noting debate over amendment allowing states to retain sales tax thresholds for clothing); Billy Hamilton, *Happy Birthday, SSUTA!*, 66 ST. TAX NOTES 513, 513 (2012) (tracing the development of the SSUTA); Joseph Henchman, *Nearly 8,000 Sales Taxes and 2 Fur Taxes: Reasons Why the Streamlined Sales Tax Project Shouldn't Be Quick to Declare Victory*, TAX FOUNDATION (Jul. 28, 2008), http://taxfoundation.org/blog/nearly-8000-sales-taxes-and-2-fur-taxes-reasons-why-streamlined-sales-tax-project-shouldnt-be-quick (detailing the failure of the Streamlined Sales Tax Project to simplify taxing jurisdictions and allowance for exemptions from uniform taxation of goods, specifically the exemptions granted to New Jersey and Minnesota for an additional fur tax on top of standard clothing sales tax); George Isaacson, *A Promise Unfulfilled: How the Streamlined Sales Tax Project Failed to Meet Its Own Goals for Simplification of State Sales and Use Taxes*, 30 ST. TAX NOTES 339, 340 (2003) (describing the failure of the SSUTA in adopting a "one rate per state" collection model for all commerce within a state, the SSUTA's failure to establish uniform definitions for products, and the increase in burdens for consumers and sellers caused by the SSUTA, amongst other issues); Eric Parker, *New Jersey Fur Tax Sparks Streamlined Governing Board Meeting Dispute*, 42 ST. TAX NOTES 853, 853 (2006) (noting criticism of New Jersey fur tax).

233. The Marketplace Fairness Act, S. 698, 114th Cong. § 2(b) (2015).

234. *Id.* at § 4(7). The sourcing rules provide that remote sales be sourced according to the delivery location or, if not available, then billing address; in the event neither are available, remote sales should be sourced to the seller's address. *Id.*

235. States that choose this option must agree to (1) notify retailers in advance of any rate changes within the state; (2) designate a single state organization to handle sales tax registrations, filings, and audits; (3) establish a uniform sales tax base for use throughout the state; (4) use destination sourcing to determine sales tax rates for out-of-state purchases (e.g., a purchase made by a consumer in California from a retailer in Ohio is taxed at the California rate and the sales tax

The bill was passed by the Senate in May 2013[236] and was introduced in the House of Representatives on February 14, 2013 but has not yet been approved.[237] A modified version of the bill was re-introduced on June 15, 2015.[238] Lawmakers are sharply divided over the bill. Senate Minority Leader Harry Reid (D-Nev.) considers passing the legislation to be "top-priority" and declares it "long, long overdue."[239] Supporters include big traditional retailers, such as Sears, Best Buy, the Gap, Barnes and Noble, and perhaps most surprisingly, Amazon, a company that spent years fighting proposals to tax online sales.[240] Commenters speculate that Amazon's support is due to the current "chaotic structure" of state sales tax regarding online purchases and Amazon would rather trade the constantly evolving laws for simplified rules that make sales tax more certain.[241] Supporters maintain that the twenty-three billion dollars of tax revenue the bill is expected to generate are taxes that are already owed, but rarely paid, and would merely "level the playing field" between online and brick-and-mortar companies.[242]

Opponents of the bill include prominent GOP lawmakers and conservative organizations.[243] They criticize it as being overly burdensome for small business owners and allege it is a method employed by big retailers to "squeeze out" small businesses.[244] More recently members of the financial service industry also expressed opposition to the bill, fearing that it could lead to unexpected costs being passed on to consumers of services, such as sales taxes on

collected is remitted to California to fund projects and services there); and (5) provide free software for managing sales tax compliance and hold retailers harmless for any errors that result from relying on state-provided systems and data. *What is the Marketplace Fairness Act of 2013?*, *supra* note 207.

236. Marketplace Fairness Act of 2013, *supra* note 227.

237. H.R. 684, 113th Cong. (2013).

238. Remote Transactions Parity Act of 2015, H.R. 2775, 114th Cong. (2015). The bill preserved the concept and framework of the MFA while changing some details. *See* Stephen P. Kranz, Mark Yopp & Eric Carstens, *Remote Transactions Parity Act Introduced in the U.S. House*, INSIDE SALT (June 15, 2015), http://www.insidesalt.com/2015/06/remote-transactions-parity-act-introduced-in-the-u-s-house/.

239. *See* Becker, *supra* note 224.

240. Brownell, *supra* note 143. Amazon also supported the Marketplace Fairness Act's predecessor. Ryan Rosso, *Senate Introduces "The Main Street Fairness Act,"* TAX FOUNDATION (August 2, 2011), http://taxfoundation.org/blog/senate-introduces-main-street-fairness-act.

241. *See* Brownell, *supra* note 143.

242. *See* Becker, *supra* note 224.

243. *Id.*

244. *See, e.g.*, Drexden Davis, *Marketplace Fairness Act is Not Fair to the Marketplace*, THE HILL (Dec. 8, 2014, 1:00 PM), http://thehill.com/blogs/congress-blog/economy-budget/226157-marketplace-fairness-act-is-not-fair-to-the-marketplace.

services or state-level stock-transaction taxes.[245] Senator Mike Enzi (R-Wyo.)—the bill's co-sponsor—offered assurances that the financial industry has "nothing to worry about" because "no state imposes a sales tax on financial transactions," but the service professional associations are not pacified, arguing that states have imposed such taxes in the past.[246]

In December 2014 supporters attempted to link the bill to an extension of the ITFA to increase the chances of passing it.[247] Although it came close, the measure was unsuccessful.[248]

3. Digital Goods and Services Tax Fairness Act

While the MFA seeks to address the current perceived *under*-taxation of digital goods and services by clarifying states' taxing powers, the DGSTFA is concerned with the *over*-taxation of digital goods and services. Although the ITFA already prohibits multiple or discriminatory taxes on electronic commerce,[249] its scope has not been litigated and remains uncertain. Legislators were concerned that due to the current disintegrated tax treatment of digital content, the same digital purchase could be taxed by several jurisdictions.[250] In answer to this concern the DGSTFA was proposed in 2010,[251] 2011,[252] 2013,[253],and again in 2015.[254] The bill would create a national framework for taxing digital content to ensure its fair and equitable treatment by creating consistent sourcing rules and uniform definitions.[255] Additionally it prohibits multiple taxation of the same purchase by more than one state and local government

245. John Berlau, *Marketplace Fairness Act: Back Door to New Tax*, INVESTOR'S BUS. DAILY (Dec. 26, 2014, 05:36 PM), http://news.investors.com/ibd-editorials-perspective/122614-732239-marketplace-fairness-act-sets-up-financial-transaction-tax.htm.

246. *Id.*

247. *See* DelBianco, *supra* note 135.

248. *Id.*

249. Internet Tax Freedom Act, Pub. L. No. 105-277, tit. XI, § 1101, 112 Stat. 2681-719 (1998).

250. *See Digital Goods*, MYWIRELESS.ORG, http://www.mywireless.org/federal-issues/digital-goods/ (last visited May 16, 2015).

251. Digital Goods and Services Tax Fairness Act of 2010, H.R. 5649, 111th Cong. (2010).

252. Digital Goods and Services Tax Fairness Act of 2011, H.R. 1860, 112th Cong. (2011).

253. Digital Goods and Services Tax Fairness Act of 2013, H.R. 3724, 113th Cong. (2013).

254. Digital Goods and Services Tax Fairness Act of 2015, S. 851, 114th Cong. (2015).

255. *Id.* at § 7.

and discriminatory taxes that impose a higher rate on a digital product than its physical counterpart.[256] The imposition of tax is also limited to the ultimate consumer of the product by barring states from taxing intermediaries.[257]

The bill has not been successful thus far. Past versions of the bill were more restrictive of states' taxing power and drew opposition. For example, the bill contained a provision that would have barred states from shaping Internet sales via administrative or regulatory means, forcing them to use the legislative process instead.[258] After complaints from the National Governors Association, the provision was removed.[259] The 2011 version also included a clause providing for federal jurisdiction for the resolution of any disputes of the Act, which was abolished in the 2013 and 2015 revision.[260] The revised version further eliminated a vague provision that would have required states to "take reasonable steps necessary to prevent multiple taxation of digital goods and digital services in situations where a foreign country has imposed a tax on such goods or services."[261] Additionally "tax" is more closely defined in the 2013 and 2015 versions, containing a longer list of exclusions where states may tax without being impacted by the Act.[262] Moreover, the 2013 and 2015 versions contain a two-year grace period for states to comply with the Act.[263] Other than increased leniency to the states, the 2013 and 2015 versions are also redrafted to arguably read more clearly, for example by refining the sourcing rules.[264]

C. Suggestions

As discussed, the three major policy considerations in reaching a federal solution are efficiency, fairness, and simplicity. While the three policy goals contain competing considerations, a good solu-

256. *Id.* at § 2.

257. Marc Heller, *Multiple Levies on Digital Goods Targeted by House Bill: Taxes*, BLOOMBERG BUS. (Dec. 30, 2013, 12:00 AM), http://www.bloomberg.com/news/articles/2013-12-30/multiple-levies-on-digital-goods-targeted-by-house-bill-taxes.

258. *See* Jake Miller, *Lawmakers Push Bill Preventing Multiple Taxes on Goods Sold Online*, CBS NEWS (Jan. 3, 2014, 1:29 PM), http://www.cbsnews.com/news/lawmakers-push-bill-preventing-multiple-taxes-on-goods-sold-online/.

259. Heller, *supra* note 257.

260. H.R. 1860, 112th Cong. § 6 (2011).

261. Digital Goods and Services Tax Fairness Act of 2013, H.R. 3724, 113th Cong. § 8 (2013).; Digital Goods and Services Tax Fairness Act of 2015, S. 851, 114th Cong. § 8 (2015). The 2015 version of the bill is virtually identical to the 2013 version except for different language in the savings provision in section 9.

262. H.R. 3724 § 7(14)(B); S. 851 § 7(14)(B).

263. H.R. 3724 § 4; S. 851 § 4.

264. H.R. 3724 § 4; S. 851 § 4.

tion should maximize those qualities. An efficient tax should not change consumers' behaviors, and therefore taxes on similar products should resemble each other. However, because digital products and their physical counterparts are not exact equivalents, their sales tax need not necessarily mirror each other. A fair tax, without adequate justification, should not overly burden one group of taxpayers over another. A simple tax should not be too difficult or costly to administer. Our current state-by-state tax system creates a patchwork result because of inconsistencies in different states' laws regarding the definition of digital content, taxability, tax rate, and sourcing rules. While alignment of all four components would create a much simpler and uniform digital sales tax framework, such a solution is not politically feasible.[265] Therefore this Note suggests that Congress do the "next best thing" and try to adopt uniform provisions for as many of the four components as possible.

This Note argues that an effective solution, at a minimum, should contain unambiguous definitions and taxability provisions that create a uniform national tax base and should adopt uniform sourcing rules. This is possible by adopting a combination of the proposed MFA with some modifications and another statute targeted toward digital goods.

1. Suggested Changes to the Marketplace Fairness Act

The MFA grants states authority to require remote sellers to withhold sales tax, provided that they either adopt the SSUTA or meet a set of simplification requirements. While this would be an improvement over subjecting sellers to the unique tax rules of hundreds of local governments and would reduce the complexity of the withholding provisions significantly, it is still far from reaching federal uniformity and simplification.

First, states' participation in the MFA is not guaranteed. The MFA does not mandate state participation and instead incentivizes participation by granting states taxing authority to collect more revenue.[266] While the taxing authority is attractive because of the revenue it generates, it is not exclusive to states participating in the MFA. Some states may choose not to meet the requirements of the

265. *Twenty Years After* Quill*, Resolution on Nexus Issues Eludes States, Taxpayers as More Commerce Goes Online*, ST. TAX ADVISORY BD. ROUNDTABLE (Bloomberg BNA), Sept. 28, 2012, at S-17, *available at* http://taxandaccounting.bna.com/btac/core_adp/get_object/state_tax_advisory_board_roundtable_fall2012.pdf (asserting that while a federal solution may be desirable, it would not be feasible because it would be perceived by the general public as a tax increase).

266. *What is the Marketplace Fairness Act of 2013?*, *supra* note 207.

MFA while still claiming taxing authority over remote sellers by maintaining their existing theories for establishing a nexus to the sellers, such as click-through nexus or affiliate nexus. While such taxing authority is not provided by the MFA, it is not denied by the current MFA either. Although Congress could rely on courts to subsequently deny that authority through statutory interpretation, such ambiguity can be dangerous, particularly because most states already claim such taxing authority. Both the taxing authority promised by the MFA and that claimed by the states can be subject to constitutional challenge, and neither is more likely to prevail than the other.

While Congress's authority is well grounded under the Commerce Clause, it is uncertain whether the MFA can withstand scrutiny under the Due Process Clause.[267] In comparison, the statutes claiming taxing authority may be subject to challenge under both constitutional provisions. While the taxing authority the MFA grants is arguably more certain than that states claim for themselves, the marginal difference may not be enough to incentivize states' participation, especially because some states may find it simpler and less costly to use their own theories to generate taxing authority.[268]

This issue can be addressed by denying non-participating states taxing authority.[269] While such a clause will likely raise federalism challenges from the states, it is likely defensible under the Commerce Clause[270] and incentivizes more states' participation. Although the clause may cost the MFA some votes, it can also increase political support by virtue of making the Act more effective. Finally,

267. It is uncertain whether the internal and external consistency requirements articulated in *Container* under the Due Process Clause apply to state sales tax issues. Container Corp. of Am. v. Franchise Tax Bd., 463 U.S. 159, 169–70 (1983). If they do the MFA will be more likely to satisfy them with more uniform laws and more state participation. See *supra* Part I.A.1 for a general study of the constitutional requirements.

268. *See supra* Part I.A.2.

269. For example, this could be accomplished by implementing a minimum taxing threshold, similar to the proposed Business Activity Tax Simplification Act of 2015, on the *non-participating states*.

270. *See, e.g.*, South Dakota v. Dole, 483 U.S. 203, 206 (1987) (upholding the federal government's withholding of highway funding to states that do not impose a minimum drinking age because "Congress may attach conditions on the receipt of federal funds, and has repeatedly employed the power to further broad policy objectives by conditioning receipt of federal moneys upon compliance by the recipient with federal statutory and administrative directives" (quoting Fullilove v. Klutznick, 448 U.S. 448, 474 (1980))).

the law surrounding this issue is murky and would benefit greatly from judicial clarification.

Second, the MFA does not sufficiently simplify the digital content sales tax system. The MFA allows states a choice between adopting the SSUTA or meeting minimum threshold simplification requirements contained in the Act. While the SSUTA contains specific uniform definitions, taxability provisions, and sourcing rules, states electing to simplify by meeting the MFA requirements may still have their own unique tax bases—so long as it is uniform within the state—and impose separate tax rates and administrative rules for each local jurisdiction. Although states making this election are required to provide sellers with software to calculate the withholding responsibilities, sellers are still faced with heavy compliance burdens. Sellers still have to contend with the different tax bases of the different states as well as different local tax rates for each locality. Nor is there a guarantee that the software would be compatible across different states. Therefore, to take advantage of the "simplifying software," the seller may have to learn to use and to enter data into multiple software systems.

Allowing the complex tax structure to proliferate is undesirable because the sellers' consequently heavy compliance burdens can result in economic dead weight loss.[271] The burdens of complying with hundreds of combinations of state and local tax rates can be reduced by providing sellers with an option to use a "blended" tax rate, which can be calculated by adding together the state tax rate and the average of the local tax rates within the state.[272] The diverse tax bases among the different states can be avoided by incentivizing states to adopt more uniform tax bases, or if infeasible, the MFA can at least require the states' software to be compatible with each other so that sellers ultimately only need to use one software.

On the other hand, this issue is not as debilitative as other issues. While not ideal this issue can also be resolved through the open marketplace. Third-party developers may see a business opportunity to develop software to facilitate small business owners' compliance with the multistate taxing regime. Assuming there will be competing developers so that no monopolies result, the software

271. *See, e.g.*, BAUMOL & BINDER, *supra* note 112, at 392–93 (stating that "the ideal tax would . . . induce no changes in economic behavior"); Feldstein, *supra* note 112 (asserting that "higher taxes hurt the economy by distorting behavior"); Avi-Yonah, *supra* note 112, at 1 (stating that efficiency is one of the three goals of taxation).

272. *See* Henchman, *supra* note 232.

should be available to business owners at a reasonable cost. Alternatively, the small business owners may also form an alliance and collectively hire software developers so that such software will be available at a more reasonable cost, but this solution comes with the added difficulty of collective action.

Third, the MFA is not comprehensive enough to address sales of digital content. Under the MFA's default sourcing rules, an Internet-based transaction should be sourced by destination, which is first determined by looking at the delivery address. When no delivery location is specified, the sale is sourced to the customer's known address or billing address.[273] In the event that neither address is available, the sale should be sourced to the seller's address.[274] As discussed,[275] in the case of digital products, there is generally no delivery address, and it is common for the seller not to know the customer's actual or billing address. This will result in many digital sales being sourced to the seller's address, which is equivalent to origin-based sourcing. This result does not conform with the notion that sales tax is paid legally and economically by the buyer and, therefore, the tax should be sourced to where the buyer receives and uses the item. It also violates the norm of sourcing interstate sales to the destination and transforms the sales tax into a business tax. Such a result is also economically harmful because economists generally agree that consumption taxes are less burdensome to economic growth than business taxes.[276]

Moreover, especially in the context of digital product sales, such a sales tax can be easily manipulated and evaded. Because companies selling digital content do not have a lot of physical inventory, it is very easy to relocate to a jurisdiction that does not tax sales of digital products or does so at a very low rate. Some argue that relocation is not even necessary for companies to engage in tax arbitrage.[277] Because "origin" is not easily definable for Internet sale, it can potentially be the place where the company has most of its employees, its state of incorporation, its headquarters, the location where the order was accepted, the place where the order was processed, the shipping location, or the location of a web server. While regulations can be written to more accurately define the "origin" of a digital sale, it is still all too easy for Internet businesses to arbitrage their location and business structure decisions based on

273. *Id.*
274. *Id.*
275. *See supra* Part II.B.
276. *See* Henchman, *supra* note 232.
277. *Id.*

tax planning, taking advantage of low, or even zero, sales tax jurisdictions and potentially causing a race to the bottom among states.[278]

Furthermore, this approach would not help correct most states' loss of revenue due to the increasing popularity of digital content because the sales tax, if any, would only be paid to the origin state. Lastly the de facto origin-based rule would also create other problems such as unjustifiable tax distinctions for similar items in the same state and taxation without representation because consumers, who are economically bearing the burden of the tax, would be taxed under the laws of a state in which they have no voting power.

Those issues illustrate the MFA's lack of comprehensiveness, which many object to, arguing that its passage would likely "undercut the momentum for more sweeping simplification."[279] However, this Note argues that this shortcoming can be overcome by combining the MFA with other legislation more targeted at specific areas such as cloud computing or digital content. Two such current proposals are the DGSTFA and the SSUTA.[280]

2. Suggested Changes to the Digital Goods and Services Tax Fairness Act

While the DGSTFA has been controversial with state legislatures, a letter from the National Conference of State Legislatures (NCSL) to the House Judiciary Committee suggests that more support could be garnered if Congress acted on it concurrently with the MFA and clarified its definitions and sourcing rules.[281] The letter acknowledged the need for creating a national framework for taxing sales of digital content similar to the framework of mobile cellular sourcing but also raised concerns about the effect on state

278. *Id.*

279. *Federal Legislation*, ST. TAX ADVISORY BD. ROUNDTABLE (Bloomberg BNA), Aug. 22, 2014, at S-33 (quoting Mr. Karl Frieden, a participant in the panel), *available at* http://taxandaccounting.bna.com/btac/core_adp/get_object/Roundtable-Special-Report-2014.pdf.

280. SSUTA is working on adopting specific rules for imposing sales tax on digital products. *See Digital Products Sourcing* (Streamlined Sales Tax Governing Bd., Issue Paper, Feb. 2, 2011), *available at* http://www.streamlinedsalestax.org/uploads/downloads/IP%20Issue%20Papers/2012/IP12003%20Digital%20Products%20Sourcing.pdf.

281. NCSL Letter to the House Judiciary Committee on the Digital Goods and Services Tax Fairness Act (HR 1860) (June 28, 2012), *available at* http://www.ncsl.org/research/telecommunications-and-information-technology/ncsl-letter-on-the-digital-goods-and-services-tax.aspx.

revenue.[282] The NCSL was concerned that the definitions and sourcing rules the bill seeks to establish are not clear enough as written.[283] Additionally it argued that adopting the Act *alone* would decrease state revenue but that, if combined with the MFA,[284] which would grant states authority to tax Internet transactions, the overall effects on states' revenues would be balanced.

This Note supports the NCSL's position. While the DGSTFA is a good first attempt at taxing digital content, its current draft version contains some ambiguities that can inspire tax evasion and deprive states of sales tax revenue. First, the Act bars state and local governments from imposing the full sales tax on "intermediaries," but the term is not well defined. This allows businesses to take advantage of the ambiguities and to structure their transactions strategically so they pay no sales tax.[285] Such a result would cause a mismatch with how similar physical goods are taxed in some states. Similarly the Act's prohibition on states' imposition of tax collection responsibility on third-party billing services may also give companies opportunities to avoid the sales tax.[286] However, such issues can be resolved by defining "intermediary" or "third parties" more precisely, either via the legislation itself or via regulation. For example, the Act could define "intermediary" and "third parties" to exclude participants who are related, owned, or controlled by either the seller or the buyer so that such participants' roles in the transaction are ignored and attributed to the related party.

Second, many take issue with the provision that if a digital good is used in multiple locations, sellers are allowed to accept the purchaser's assertion as to where the good is primarily used.[287] The

282. *Id.*

283. *Id.*

284. The letter referred to the Main Street Tax Fairness Act, H.R. 5660, 111th Cong. (2010), which is the predecessor of the MFA.

285. *See* Michael Mazerov, *Proposed "Digital Goods and Services Tax Fairness Act" Likely to Do More Harm Than Good in Current Form*, CTR. ON BUDGET AND POL'Y PRIORITIES (Aug 11, 2011), http://www.cbpp.org/sites/default/files/atoms/files/8-11-11sfp2.pdf (discussing the vulnerabilities of the Act).

286. *Id.* at 7–9.

287. *Id.* at 6–7; Digital Goods and Services Tax Fairness Act of 2011, H.R. 1860, 112th Cong. § 4(c)(2) (2011) ("If the sale of digital goods or digital services is made to multiple locations of a customer, whether simultaneously or over a period of time, the seller may determine the customer's tax address or addresses using the address or addresses of use as provided by the customer."). The 2013 and 2015 Acts have similar language. *See* Digital Goods and Services Tax Fairness Act of 2013, H.R. 3724, 113th Cong. § 4(e)(1) (2013); Digital Goods and Services Tax Fairness Act of 2015, S. 851, 114th Cong. § 4(e)(1) (2015) ("If a digital good or a digital service is sold to a customer and available for use by the customer in multi-

original motivation may be to reduce sellers' compliance burdens so that they would not have to conduct complex investigations into buyers' practices to complete their tax withholding obligations. However, this provision also opens the door to creative tax planning or outright evasion. To balance the two legitimate concerns the legislation could allow sellers to accept the assertions of individual customers while subjecting sellers to more investigative duties with respect to commercial purchasers[288] because the latter are more capable of and have more incentive to structure transactions strategically to lessen the tax burden. Such a clause would still lessen the seller's overall compliance costs while also reducing states' concerns about losing revenue. In addition, the legislation may subject buyers to a "good faith" requirement in properly reporting their place of use, the violation of which could potentially trigger federal tax fraud sanctions. Alternatively, the states could be allowed to perform tax audits with the buyers and impose liability for any sales tax shortages due to misrepresentations while holding the sellers harmless if the sellers acted in good faith.

Third, many definitions of the DGSTFA reference definitions issued by the state and local taxing authorities, which can allow multiple complex tax rules to proliferate. For example, section 4(e)(2)(A) of the DGSTFA allows "qualified customers" to pay taxes directly to the state and local jurisdictions, but the Act later states that the term will be defined by individual state or local governments.[289] The definitions are unlikely to be uniform among the different state and local governments. Variances among the definitions will mean that sellers will continue to be subjected to multiple sets of rules.

Lastly and most troublingly, while the DGSTFA contains uniform guidance for how digital content should be sourced, it is inconsistent with the proposed guidelines in the SSUTA, to which twenty-four states currently conform.[290] This is problematic both politically and practically. The inconsistencies may be detrimental to generating sufficient political support for the bill. The twenty-four states that adopted the SSUTA *could be* the bill's most likely supporters because they have expressed a preference for federally

ple locations simultaneously, the seller may determine the tax addresses using a reasonable and consistent method based on the addresses of use as provided by the customer and determined in agreement with the customer at the time of sale.").

288. For example, sellers could be obligated to check business records.

289. S. 851 § 4(e)(2)(A).

290. *See* Mazerov, *supra* note 285.

uniform sales tax laws through adoption of the SSUTA. However, by participating in SSUTA's drafting, the states have espoused a policy preference which is unfortunately inconsistent with the DGSTFA. Those states may object to those inconsistencies both on a policy level and because of the high implementation costs. Moreover, because there is no basis for believing that the DGSTFA sourcing rules would over-perform those proposed by the SSUTA, it is difficult to justify requiring SSUTA states to switch to DGSTFA rules. While some changes to some states' laws are an inevitable product of national uniformity, it would be preferable to limit the aggregate amount of changes necessary, both to generate more support for the bill and to make for an easier transition. Furthermore, the inconsistencies would cause incompatibility with the MFA, which references the SSUTA. Given that the DGSTFA standing alone has been predicted to result in state revenue losses,[291] the incompatibility is undesirable because state representatives are unlikely to agree to its adoption unless it is presented as part of a "package" with the MFA.[292]

CONCLUSION

While the most attractive attributes of digital content such as Internet streaming may be convenience and a "fuss-free experience," its taxation is anything but easy because of the many competing considerations involved. This Note does not aspire to provide a solution to the complicated problem. Rather, by laying out the major issues, it intends to provide a jumping board for future solutions or at least provide something interesting to ponder during commercial breaks while streaming one's favorite shows. One issue is maintaining a delicate balance between preserving states' sovereign power to impose sales taxes, which has traditionally been regulated by individual states, and fostering economic growth by preventing excessive burdens to interstate commerce. Another consideration is finding a balance among efficiency, fairness, and administrability. On one end of the spectrum, one could impose a flat rate federal tax on digital content and apportion the proceeds among the various states by population or Internet access. While such a tax would be easy to impose and administer, it would also be similar to a head tax and may not sufficiently address fairness and efficiency concerns. On the other end of the spectrum, one may design the tax to

291. *See, e.g.*, Mazerov, *supra* note 152.

292. *See* NCSL Letter, *supra* note 281 (suggesting that support for the DGSTFA is conditional on its concurrent passage with the MFA).

exactly mirror the tax on the physical product. While such a tax would serve the efficiency considerations,[293] it would be difficult and costly to administer, particularly when taking into account the fact that one of the primary consumer groups of streaming products is the extremely mobile population. The administrability issues are especially prominent when picturing a traveler who may be streaming the same movie while crossing multiple states or a commuter who may use digital content on twice-daily commutes across state lines. The existence of hundreds of different local sales tax systems further complicates the issue. To address those concerns, the Marketplace Fairness Act and the Streamlined Sales and Use Tax Agreement have sought to develop uniform tax rules, at least at the state level.

In addition to the practical issues of designing an appropriate sales tax for digital products, there are also complex constitutional concerns. Any state- or federal-level proposals must take care not to violate the Commerce Clause or Due Process Clause, which respectively provide that the taxes must not over-burden interstate commerce and that sellers can only be obligated to withhold sales tax if they "purposefully directed" their activities toward that state. While federal solutions passed by Congress may have a lower Commerce Clause hurdle, state-level solutions must be mindful of both constitutional requirements. With the last major Supreme Court case more than twenty years old and widely criticized as unclear, the lack of recent judicial guidance on this subject also makes the task more daunting.

Further complicating the question are political issues and sharply divided public opinions. Because many digital products are currently not subject to tax, any proposed taxation measures will likely be perceived as a tax increase unpopular with Internet businesses and consumers, while any restrictions on states' ability to tax will be seen to damage states' sovereignty and already-diminished revenue and perceived as unfair by traditional businesses. Public opinion is likely to be sharply divided, and generating sufficient support for any kind of political action will be difficult. It may not be feasible to successfully pass legislation that creates a perfect digital content sales tax system, but measures can be taken to build a simpler and more uniform one.

This Note argues that a combination of a modified MFA and another law specifically addressing digital commerce, such as the

293. This assumes one believes that digital and physical products are exact equivalents, which is debatable. *See supra* Part II.A.

DGSTFA or the SSUTA, is the most likely winning combination. This combination would engender state support because (1) the MFA grants states additional tax authority and is estimated to generate revenue; (2) by simultaneously restricting the probability of multiple taxation on the same transaction via carefully drafted sourcing rules, the combination limits potential objections from the business community; (3) twenty-four states have already adopted the SSUTA, which the MFA references, and therefore would not find the new legislation overly burdensome; and (4) the combination is more likely to be constitutionally valid than individual states' theories, at least on the Commerce Clause issue, because it would have congressional blessing and create a simplified system lessening excessive burdens on commerce. However, the MFA must be modified to make the grant of taxing power exclusive to incentivize sufficient state support. The MFA could also further simplify the sales tax system by requiring all states to provide an option for sellers to use a "blended" state and local tax rate and by ensuring compatibility among the tax compliance software states provide sellers.

Lastly a resolution should be reached as quickly as possible. This is a very important issue requiring careful consideration because digital content will only become more ubiquitous as technologies progress. The decision of how to tax digital products will be a milestone and likely set a precedent for future taxes. However, despite the hurdles the legislative bodies have to cross, the tax should be passed in a timely fashion because the longer we allow the current fragmented taxing scheme to stand, the more controversial the issue will become, as digital content businesses increasingly see the status quo of "no tax" or "low tax" as a birthright. Moreover, as the debate rages on, some businesses will continue to benefit from the chaos through tax loopholes. This result is not only arbitrary and unfair but also causes an unjustifiable loss of valuable state tax dollars.

APPENDIX: SURVEY OF STATES' TREATMENT OF DIGITAL GOODS AND SERVICES

State Name	**Definitions**			**Taxability**		
	SST Definition	Other Definition	No Definition	Affirmative Tax	Implicit Tax	Exempt
Alabama			Y		Y	
Alaska	NA					
Arizona			Y		Y	
Arkansas		Y			Y	
California			Y			Y
Colorado			Y		Y	
Connecticut		Y			Y	
Delaware	NA					
D.C.			Y			Y
Florida			Y		Y	
Georgia		Y				Y
Hawaii			Y		Y	
Idaho			Y		Y	
Illinois		Y			Y	
Indiana	Y			Y		
Iowa		Y				Y
Kansas		Y				Y
Kentucky	Y				Y	
Louisiana		Y			Y	
Maine		Y			Y	
Maryland			Y			
Massachusetts			Y			Y
Michigan		Y				Y
Minnesota		Y			Y	
Mississippi		Y		Y		
Missouri			Y			Y
Montana	NA					
Nebraska	Y			Y		
Nevada	Y					Y
New Hampshire	NA					
New Jersey	Y			Y		
New Mexico			Y		Y	
New York			Y			Y
North Carolina		Y		Y		
North Dakota	Y					
Ohio		Y		Y		
Oklahoma		Y				Y
Oregon	NA					
Pennsylvania			Y			Y
Rhode Island	Y					Y
South Carolina			Y			Y
South Dakota			Y		Y	

Tennessee	Y			Y		
Texas		Y			Y	
Utah		Y		Y		
Vermont	Y			Y		
Virginia			Y			Y
Washington	Y			Y		
West Virginia		Y				Y
Wisconsin	Y			Y		
Wyoming	Y			Y		