Overview Of The Digital Economy And State Tax Policy

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WHAT IS THE DIGITAL ECONOMY THAT ARE WE TALKING ABOUT?

LET'S START WITH "WHAT IS DIGITAL TECHNOLOGY?"

- Relies on the use of microprocessors (tiny computers on an electronic chip) that process, store, and transmit information in the digital language of 0's and 1's; and
- Results in information, communications, and operations technologies (the "internet of things") that now infuses every sector of the economy.
- Digital technology is transforming the economy, communications, social relationships, access to and operation of basic government services, and almost every other aspect of society and culture.

WHAT IS THE DIGITAL ECONOMY?

- The digital economy can be defined many ways:
  - “An economy that is based on digital computing technologies but is often perceived as conducting business through markets based on the internet and World Wide Web.” ("Defining, Conceptualising and Measuring the Digital Economy").
  - The economic activity that results from billions of everyday online connections among people, businesses, devices, data, and processes. (Deloitte)
  - The worldwide network of economic activities, commercial transactions and professional interactions that are enabled by information and communications technologies. (Tech Target)
- And many variations on the theme in academic and legal papers that dive into it.

How Big Is the Digital Economy?

10.2% of U.S. GDP

or **$2.1 trillion** in 2020

6.3% average annual **growth**

from 2012 to 2020, value added adjusted for inflation

Led by growth in insfrastructure and e-commerce

7.8 million jobs in 2020

2.5% average annual growth, 2012–2020

$1.1 trillion
in total compensation in 2020

HOW THE US BUREAU OF ECONOMIC ANALYSIS DEFINES IT

3 key elements: Infrastructure, E-commerce, Priced Digital Services

- **Infrastructure:**
  - Computer hardware, plus communications, and audio/video products
  - Software – all varieties, formats, and uses
  - Structures – buildings creation of goods and services; where the cloud is stored
- **E-commerce**
  - Business-to-Business
  - Business to Consumer
  - Includes most goods and counting services is a work in progress

bea
Bureau of Economic Analysis
U.S. DEPARTMENT OF COMMERCE

BEA DEFINITION - CONTINUED

- **Priced digital services**
  - Cloud services
  - Telecommunications services
  - Internet and data services
  - Digital intermediary services
  - All other priced digital services
- Some challenges
  - Interactive Platforms - Unpriced and blended priced
  - Digital advertising and sale of personal information (internet-based)

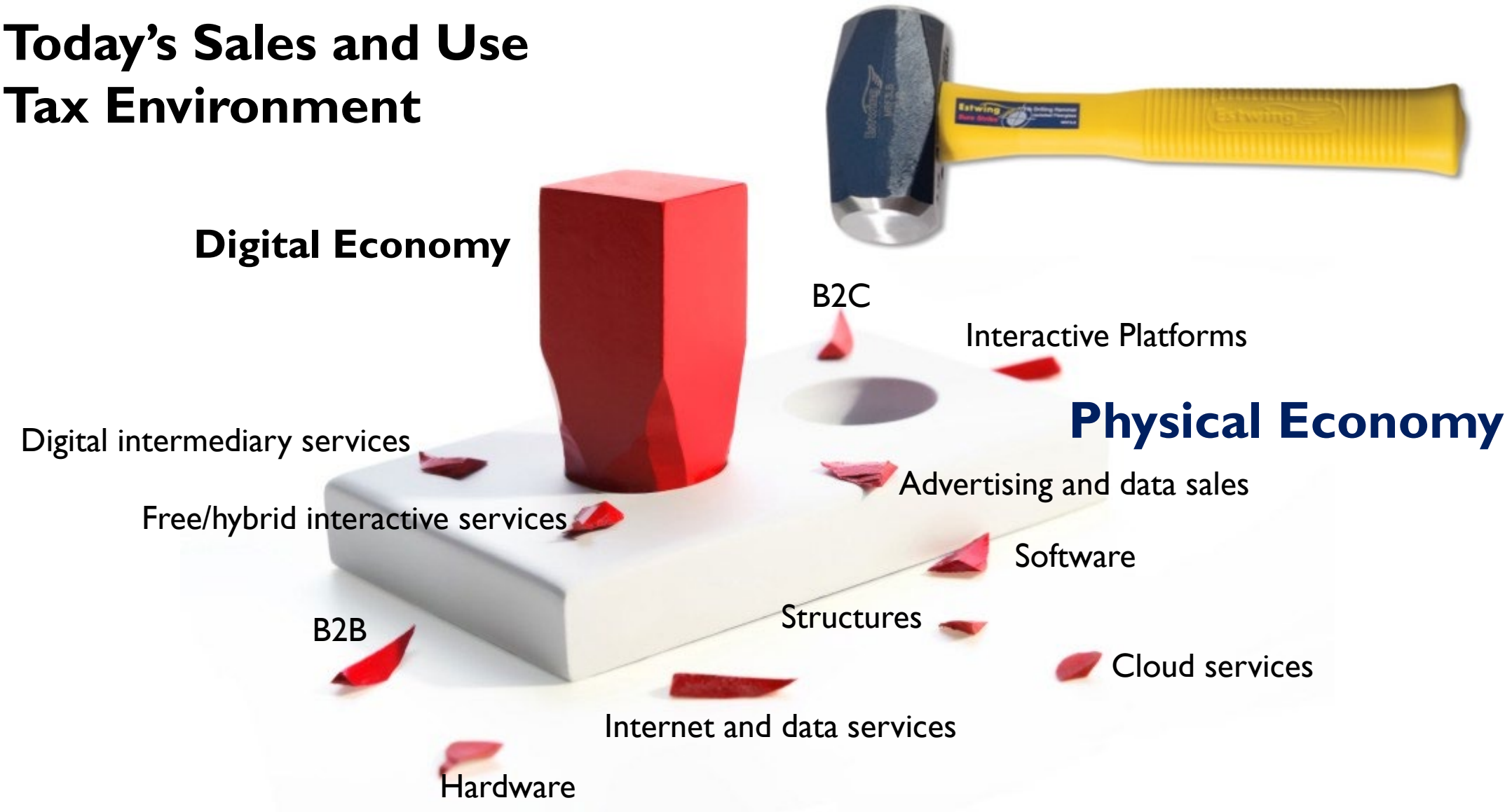
WHAT'S **ITFA** GOT TO DO WITH IT?

THE (PERMANENT) INTERNET TAX FREEDOM ACT

- Prohibits state or local taxation on internet access. Does not address taxation once you access the internet.
- Prohibits multiple or discriminatory taxes on electronic commerce.
  - Includes discriminatory Internet-only taxes such as bit taxes, bandwidth taxes, and email taxes.
  - Bans multiple taxes on electronic commerce. It essentially mean you must tax similar physical and digital products the same.
  - Challenge is what is "similar" or "analogous"

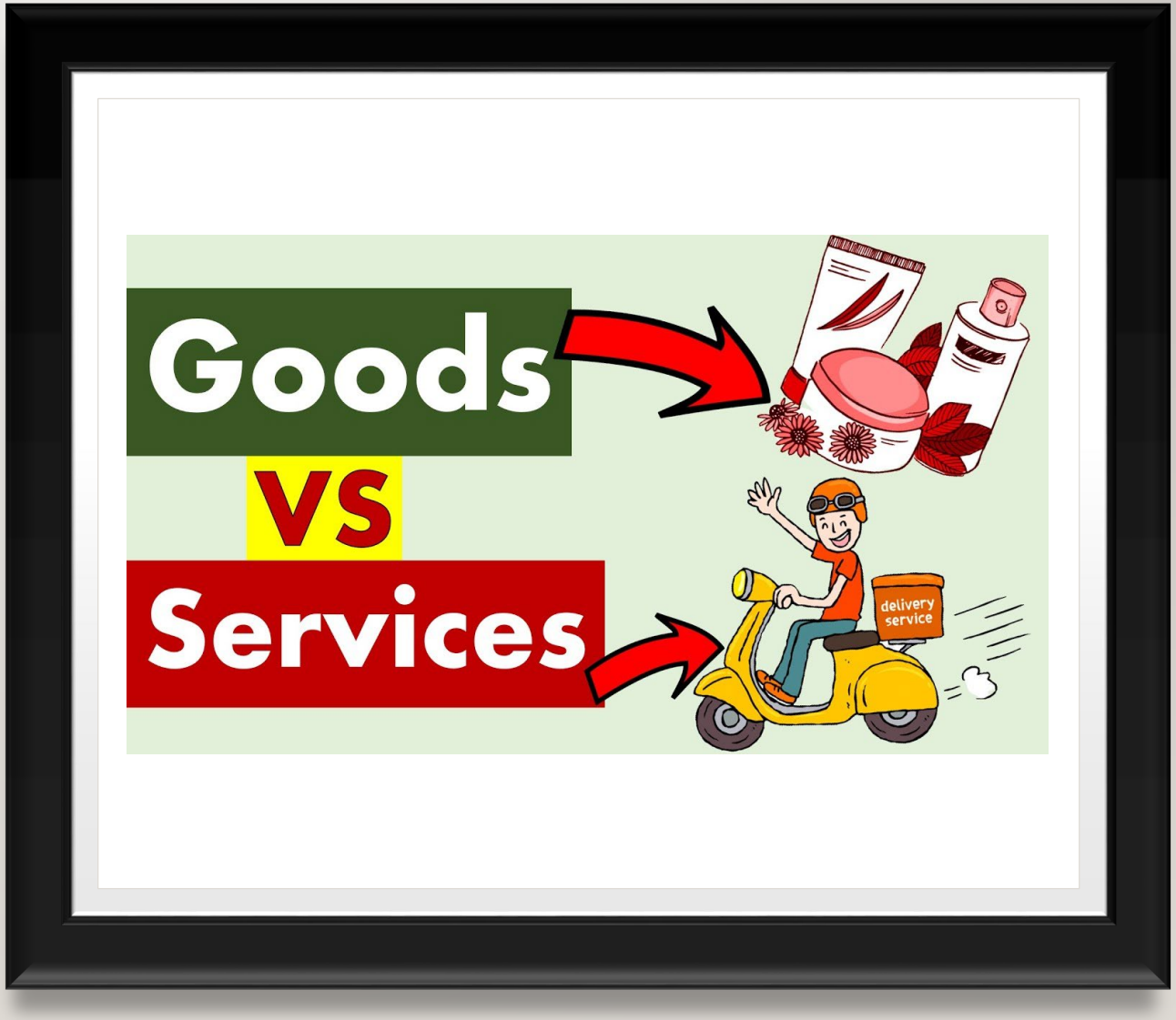
IMPACT ON TAX POLICY – SALES AND USE TAX

Today's Sales and Use Tax Environment



PHYSICAL (TRADITIONAL) PRODUCTS DOMAIN

- Traditional tangible (taxable unless specifically excluded) and intangible goods (non-taxable)
- Human-delivered services taxable by enumeration; covers human services supported by technology



DIGITAL PRODUCTS DOMAIN: GOODS AND SERVICES

- Treat digital products as taxable by default
- Subject to:
  - Appropriately broad definition of digital
  - Supported by common definitions and reporting
  - Exclude products that are true business inputs (as done in the physical world)
  - Subject to state-by-state exemptions for policy
  - ITFA compliance with the physical domain analogues

DIGITAL SERVICES AND ROLE OF HUMAN LABOR

- Differentiated from physical domain by human labor/expertise not being principally engaged in providing the output received by the buyer
- With a digital service, the *true object test* is driven by the technology doing the work and providing the output, rather than human labor .
- ITFA will be a challenge
  - Prohibits discriminatory taxes on electronic commerce; uses the principle of "analogous" to treat physical and digital products
  - But in many ways, similar services are different. And some are not based on the internet or are hybrids.
  - Challenge will be what the courts consider to be analogous.

DIGITAL'S IMPACT ON OTHER TAXES

VEHICLE PURCHASES AND USE TAXES

- Electric Vehicles/Automated Vehicles - sales taxation and clean energy incentives
- Challenge of fuel taxation – how to tax electrons sold at many places and replace fuel purchases at a fixed number of places
- Registration fees – can EV/AV registration fees replace fuel taxes?
- Vehicle Mileage Travelled tracking (VMT) – data collection and use, billing and collection
- Some technology solutions may help any of these approaches, but policies needed on data collection and use

TELECOMMUNICATION TAXES

- ITFA bans taxation on internet access
- Legacy public utility regulatory policy is failing (e.g., disappearing landlines)
- (Unregulated) VOIP (replaced those landlines) and robust competition from other competitors operating under different tax regimes
- Changes in legacy cable television market moving to streaming and regulatory issues
- Digital divide on low-income residents and underserved urban and rural areas
- Given the changes existing tax policies are not producing the expected revenue
- Need separate studies to reflect how the digital technology is affect this realm

GROSS (PERSONAL) AND CORPORATE INCOME TAXES

- Valuing digital and virtual asset investments and sales transactions; profits and losses (aka, cryptocurrency, NFTs)
- Workplace changes from physical, to virtual, to hybrid and nexus/sourcing challenges for taxpayers (individual and business) on how much is paid when and from whom
- Impact of “gig” workers on state worker protection and benfit laws
- Changes in business structures and impact on under which tax regime they file
- As with sales and use, telecom, and vehicle taxation, the round hole of how we tax income doesn’t fit well with the square peg of digital

REAL ESTATE PROPERTY TAXES

- Did not look a personal property taxes
- Development and operation of cloud facilities
- Impact of physical goods warehouses for e-commerce fulfillment
- Impact on jobs, traffic, local revenue vs. environmental issues

INHERITANCE TYPE TAXES

- Policies related to valuing and holding digital assets

MOSTLY LOCAL TAXES

- Local versions of sales and use – complications of definitions, rates, nexus, and sourcing (especially with marketplace actors)
- Transportation Networking (aka, Ride Sharing) Companies (Uber, Lyft, et al.)
  - Rides, delivery and micro-mobility services
  - Gig employment law related issues: contractors vs. employees
- Transient Housing Rentals (AirBnB, Vrbo, etc.)
  - Competition with existing realtors for rentals
  - Sales tax and occupancy taxes can be very local and have administrative complexity
  - Displacement of family and affordable housing supply impact
  - In some cases, tourism related taxes and fees

ADMINISTRATIVE AND INSTITUTIONAL CAPACITY

- Legislatures and tax agencies need to develop understanding of digital and develop relevant policies.
- Taxpayer and compliance policy issues
  - Addressing compliance costs of businesses
  - Confusion with marketplaces and their sellers and tax liabilities
  - States should be working with regional and national organizations to develop common definitions and common reporting practices.
- Agency technology tools
  - Taxpayers expect agencies to leverage tech like they do
  - When upgrading, maintain and support the existing tech until the new system is rolled out.

DATA AND ADVERTISING

- Websites and apps collect data that creates business revenue streams, most notably used to sell advertising; which has resulted in significant corporate use of tax avoidance practices
- International tax laws are under development to limit these practices and share tax proceeds fairly
- Simultaneously, several US states see digital advertising revenue as a taxable service
- Potential challenges to taxing digital advertising includes:
  - Compliance with ITFA requirement for consistency with non-digital tax policy
  - US constitutional questions about taxation of advertising as an imposition on free speech
  - Potential conflict with tax policies at the federal and international levels
  - Corporate opposition and their influence in legislative politics
  - Concerns about personal privacy and potential for surveillance of individual practices
- Result: Legal, economic, and government policy research and practice needs to evolve

WRAPPING IT UP

- The underlying principles of many current taxes don't work for digital. SUT is a good example
- Most state tax laws were not designed to address the evolving economy, much of which is digitally driven
- At the end of the day, the digital economy and tax policy comes down to recognizing that:
  - Economic behavior can now ignore borders of individual states; thus, adaption by states is necessary, like the international tax avoidance challenge.
  - Adapting to evolving technology and business practices requires reconsideration of underlying assumptions and a rebalancing of interests by businesses, regulators, and tax administrators.
  - It goes beyond sales and use and similarly affects other taxes; income and vehicles are good examples
- The economy we knew is not the economy we have

QUESTIONS?