New York City Independent Budget Office Fiscal Brief

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To Tax or Not to Tax the New Economy:

Digital Goods and Sales Taxes in New York

Summary

Media goods in digital form, such as downloaded music, videos, and e-books, are not currently subject to either the New York City or New York State general sales tax. These goods have become increasingly popular with consumers while sales of physical CDs, DVDs, and books have fallen off. The shift towards digital goods and away from their taxable physical equivalents has eroded the sales tax base in New York and is likely to continue to do so. Many other states have decided to include digital goods in their sales tax base in order to prevent revenue erosion and avoid treating sellers and consumers of equivalent goods differently.

In this fiscal brief, IBO focuses on media goods—music, videos, and e-books—that are delivered electronically. It begins with a background discussion of the growth in sales of digital media and the economic rationales for and against including digital goods in the sales tax base, then presents a short overview of digital goods taxation in other states, and concludes with a look at the revenue implications for New York City and New York State. The findings include:

- If the market continues its shift towards digital and away from physical formats, $41 million of current New York City tax revenue from the sale of physical media goods is at stake.
- Extending the sales tax base to include downloaded and streamed music, videos, and e-books would yield $21 million in additional annual revenue for New York City. This figure will grow over time as sales of digital goods continue to increase.
- In New York State, sales tax revenue from physical media goods currently totals about $76 million a year and extending the tax to cover their digital equivalents would yield $38 million annually.

If New York State and City want to consider extending the sales tax to digital goods, they could examine the approaches of many other jurisdictions. All digital media goods are subject to sales taxes in the District of Columbia and in over half of the 45 states that have a sales tax.

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Background

One of the consequences of the Internet revolution has been a marked change in the form and distribution of media goods, particularly music, videos, and books. Once available only in tangible form, these goods can now be delivered online in a digital form to customers without any transfer of physical property. In recent years, digital sales of each of these three types of media goods have greatly increased at the expense of sales of the equivalent products in physical form. In 2014, music in digital formats accounted for over two-thirds (67.4 percent) of music sales in the United States, up from the over 40 percent share it held in 2009. In the $17.8 billion home entertainment market, the share of digital sales, subscription, and video-on-demand services was 42 percent in 2014, up from just over 10 percent in 2009—with a large share of the growth attributable to subscription services like Netflix and Amazon Prime. And in the eight years since Amazon introduced the Kindle, e-books have grown to approximately 20 percent of the book market.[1]

This brief focuses on the taxation of digital media since these goods, which are tax-exempt in New York State, are substitutes for equivalent taxable goods.[2] The trend toward digital sales of these goods is eroding city and state tax revenue because only sales of the tangible forms of these products are subject to sales taxes in New York; sales of digital media goods—books, music, and videos delivered to customers in digital form—are not taxed. For example, the sale of a book is taxable while the sale of an e-book with the exact same content is not.[3] If the shift towards digital goods continues, the sales tax base in New York will erode further, as a diminishing fraction of sales of media goods would be taxable. Over time, increasing amounts of tax revenue will be foregone due to the tax-exempt status of digital sales.

A proposal by then-Governor David Paterson to include digital media goods in the state and local sales tax base was abandoned during negotiations over the 2009-2010 state budget. At least part of the opposition to the Governor's plan stemmed from grouping the digital goods proposal with a number of other proposed additions to the sales tax base, including personal service fees, and movie and concert tickets. The New York State Tax Reform and Fairness Commission's final report to Governor Andrew Cuomo (November 2013) included taxing digital media goods among its options for tax reform.

Pros & Cons. Proponents of extending sales taxes to digital goods cite several economic rationales, besides increasing tax revenue, for doing so. Current tax law does not treat consumers equally when they purchase the same product in different formats, disadvantaging customers of physical goods relative to buyers of digital goods. This asymmetry also adds to the regressivity of the sales tax, as the average income of households with Internet access is greater than the average of households without Internet access, making it very difficult if not impossible for the latter to purchase digital goods. Moreover, among households with Internet access, those who buy online also tend to have higher-than-average incomes.[4] Similarly, there is also unequal tax treatment among businesses that sell media goods: vendors of physical books, music, and movies are required to charge tax while vendors that specialize in digital goods are not, even when both are selling the same content.

Opponents of extending the tax base argue that digital goods remain different from their physical analogues in that they cannot easily be resold. While Amazon and iTunes have obtained patents to set up secondary markets, these markets are not currently in operation and are likely to face legal challenges. Moreover, sourcing the purchase—determining the buyer's residential location—is not always straightforward for sales of digital goods, since the location of the selling business is not relevant and there is no physical shipment address in sales of digital goods.

Digital Goods Taxation in the States

State taxation of digital media goods is a complex and evolving issue and approaches to taxing digital goods diverge widely among the states. Given that state sales tax laws, such as New York's, are almost exclusively tied to the notion of taxing tangible goods, states that have sought to tax digital products have had to develop alternative approaches. And with new digital products coming online at a fast pace, state sales tax laws have had difficulty keeping up.

The roughly half the states that tax digital goods have taken a variety of approaches. Some states, such as Louisiana, broadly define tangible personal property to include "anything perceptible to the senses"—a definition that would cover digital media. Other states tax digital goods if the good's tangible equivalent is taxable. For example, Texas is able to charge sales tax on e-books because book sales in Texas are subject to tax.

Harmonizing the Definition of Digital Goods. Other states have adopted statutory language that makes digital goods explicitly taxable. The Streamlined Sales and Use Tax Agreement (SSTUA)—a multistate effort to harmonize the sales tax—has been especially important in this area. SSUTA's 24 member states, a group that does not include New York, are required to adopt uniform definitions of digital goods. Some SSUTA members have chosen to extend their sales tax base to tax digital goods after adopting these definitions, as Wisconsin did in 2009. Conversely, North Dakota decided not to tax digital goods after adopting the SSUTA definitions.[5]

In order to keep pace with ongoing development of new digital products, some states have developed comprehensive systems of digital taxation on their own. Washington is a notable example. Following the recommendations of a committee of business and government representatives, the Washington Legislature overhauled the state's sales tax on digital transactions in 2009. Besides adopting the SSUTA definitions of three specific digital goods—music, video, and books—the legislation defined digital goods to include "sounds, images, data, facts, or information, or any combination thereof, transferred electronically."[6] This implies, for example, that sales of stock photos or subscriptions to financial information are taxable. The new system also defined and taxed remote access to prewritten software ("cloud computing") and digital automated services like online search engines.

Revenue Implications of Taxing Digital Media

Using data from the federal Bureau of Labor Statistics 2013 Consumer Expenditure Survey and industry sales data from 2014, IBO has estimated two key revenue impacts: the tax revenue attributable to sales of physical books, CDs, DVDs, and other tangible formats of taxable media goods and the tax revenue forgone by not taxing sales of their digital equivalents. Industry data on the sales of media goods is available only at the national level. IBO used data on state and local household consumer expenditures in conjunction with the U.S. data on sales of media goods to estimate the city's and state's shares of national sales of media goods in both physical and digital form.[7]

IBO estimates that city sales tax revenue from physical media goods in 2014 was $41 million, down from $51 million in 2009, just 5 years earlier. For the state, sales tax revenue from physical media goods totaled $76 million in 2014, down from $94 million in 2009. It is likely that the shift from sales of physical media goods to sales in digital formats will continue, reducing sales tax revenue in the future. But sales of physical media goods are unlikely to disappear entirely, so our estimates should be considered the maximum amount of tax revenue that could be lost in the course of the shift towards digital formats.

2014 Sales Tax Revenue
Dollars in millions

	Physical Media Revenue at Risk		Digital Media Revenue Currently Foregone	
	New York		New York	
	City	State	City	State
Music	$4	$7	$7	$13
Video	16	30	9	16
Books	21	39	5	9
Total	**$41**	**$76**	**$21**	**$38**

SOURCES: Bureau of Labor Statistics; Recording Industry Association of America; Digital Entertainment Group; and Association of American Publishers

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IBO also estimated the tax revenue that would have been generated if the New York State and New York City sales tax base had included all media goods in digital form. In 2014, the revenue forgone by not taxing these digital goods was $21 million for the city and $38 million for the state. The latter figure is more than 8 percent higher than the estimate provided by the state's Tax Reform and Fairness Commission ($35 million) in 2013, reflecting growth in the digital market since the commission's estimate was made. We expect forgone revenue to grow in future years as purchases of digital goods make up an increasing share of the market.

Without a Change, Continued Erosion of the Sales Tax Base

While most states with a sales tax have extended their sales tax base to include digital goods, digital goods are still tax-exempt in New York State, despite the growing share of digitally delivered goods in the media markets. IBO's estimates suggest that New York City would have collected $21 million in additional 2014 sales tax revenue if digital music, video, and books were made taxable, while the state would have collected $38 million more. These forgone tax revenues will likely grow as the market for media goods in digital form continues to expand.

Taxing physical media goods while leaving digital goods tax-exempt makes the general sales tax more regressive as higher income individuals are more likely to consume digital goods given their greater access to the Internet and ability to make purchases online. Continuing to exempt the sales of digital goods also provides businesses specializing in the sale of these products an unfair advantage over those that primarily sell physical media goods. However, the inability to resell digital media goods continues to distinguish digital media from physical media, calling into question whether digital and media goods are true substitutes for one another.

Physical media goods accounted for sales tax collections of $41 million in New York City, down from $51 million in 2009. Failure to recognize changes in the media goods market with a corresponding change in the sales tax base will result in continued erosion of sales tax collections going forward, as new products provided over the Internet will continue to go untaxed. While these figures seem small compared with current sales tax collections, the taxation of digital goods will become a more pressing issue over time as more newly developed goods and services—such as cloud computing—will be intangible and therefore not automatically included in the sales tax base.

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Endnotes

[1]Industry data on digital music and video sales are from the Recording Industry Association of America and the Digital Entertainment Group, respectively. Data on book sales are from the Association of American Publishers and Nielsen BookScan.

[2]This brief uses the term "digital goods" to refer to goods delivered electronically. In contrast, purchases made electronically and delivered in physical form are already taxed by New York State and localities, assuming nexus requirements are met. Software is the only digital good currently taxed in New York State.

[3]See New York State Department of Taxation and Finance,Technical Memorandum TSB-M-11 (5) S, 2011.

[4]Goolsbee, Austan "In a World without Borders: The Impact of Taxes on Internet Commerce," Quarterly Journal of Economics, Vol. 115, No. 2, May 2000, pp. 561-576; Zickuhr, Kathryn, Smith, Aaron "Digital Differences," Pew Research Center, April 2012.

[5]Duncan, Harley and Michelle Andre, "What's News in Tax: Sales and Use Taxation of Digital Products," KPMG Report, 2009.

[6]See Washington Administrative Code, Title 458, Chapter 20, Section 15503, and Allen, Caleb and Bob Heller, "Taxing and Sourcing Digital Transactions in Washington State," State Tax Notes, Vol. 66, No. 2, October 2012, pp. 117-124.

[7]All estimates are based on national data on sales of digital and physical books, music and videos and the 2013 Consumer Expenditure Survey from the Bureau of Labor Statistics. Data on revenue from the sale of music, video, and books in the U.S. were obtained from the respective trade associations. The data include spending on streaming services for music and video, which are taxed by most states that tax digital goods, but could also be exempted from digital goods taxation. The main rationale for taxing these services is that their closest physical equivalents, traditional movie rentals, are also subject to sales tax in New York. Digital video estimates do not include video-on-demand services offered by cable providers since cable television services are tax-exempt in New York State and taxing video-on-demand would first require consideration of extending the sales tax to cable television services.