Legislation Analysis

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Eliminating Taxation of Cloud Computing and Streaming Services under HB2479 and SB1392 Not Wise

Summary:

Last week the Arizona House approved HB2479 39-19 to eliminate taxing of streaming services or cloud services on companies that did not allow a download option. A companion bill SB1392 awaits action on the Senate floor and may have a floor debate and vote this week.

These identical bills have the potential to be a significant revenue hit if not now, then in the future. The Arizona League of Cities and Towns estimates the revenue loss to state and local governments is $180 million. The Joint Legislative Budget Committee (JLBC) has not identified a specific amount, but has determined this legislation would be a net loss to the General Fund. Because the state, due to lack of revenue growth, now runs a permanent austerity budget (See GCI State of the State Budget: The Revenue System is Broken), any revenue loss should be avoided when possible.

Action now is also premature as the U.S. Supreme Court will hear *South Dakota v. Wayfair* on April 17 with a ruling by the end of June. That decision will determine what parameters can be used by states in determining tax liability for e-commerce transactions involving vendors without a technical physical presence in the state.

These factors suggest the state would be advised to wait until after the U.S. Supreme Court decision before setting Transaction Privilege Tax (TPT) and use tax policy on e-commerce.

Detailed Analysis:

The economy has evolved as more goods that formerly were accessed in stores or downloaded onto your computer are increasingly moving to cloud and streaming services. Taxing by this legislation would be determined by the means accessed as opposed to the product itself. A ticket at a movie theater is taxed; buying or renting a movie on a DVD it is taxable. Downloading the movie to rent or buy is taxable, but under HB2479/SB1392 if it is streamed but cannot be downloaded the product would not be taxed. That contrasts with the interpretation of the Arizona Dept. of Revenue (DOR) that tangible personal property (TPP) includes software and digital products regardless of how they are delivered. DOR reached their interpretation based on how TPP as defined in statute as being "perceptible to the senses" (ARS 42-5001 (17)) and case law from Arizona Supreme Court decisions (See July 31st Meeting of Ad Hoc Joint Committee on the Tax Treatment of Digital Goods and Services, Dept. of Revenue presentation).

Taxing streaming services is common in many states including Nebraska, South Dakota, Wisconsin, Iowa, Minnesota, Ohio, Washington, Florida, Pennsylvania and others. Consequently, while clarifying digital products especially in the Software as a Service (SaaS) e-commerce classification such as cloud computing is important, the proposed legislation narrows existing practice of DOR in defining TPP. This means it will result in a revenue loss—and so a fiscal note should have been generated early on.

While the bill was drafted by some, but not all, of the legislators that sat on an intersession ad hoc committee, the Ad Hoc Committee on the Tax Treatment of Digital Goods and Services never carefully examined possible fiscal impacts. A fiscal note was not completed before hearings in committees on February 14th. That fiscal note requested by Senator Karen Fann did not emerge until March 1st, the day after the House had already passed the bill.

The fiscal note includes a number of concerns.

1. The Joint Legislative Budget Committee (JLBC) "estimate(s) the bill would result in a General Fund revenue loss." However, they also note records are not sufficient to easily calculate the loss, but JLBC has concluded that some areas currently taxed would no longer be taxed under this legislation. A proper study would take months to produce and should be a forethought, not an afterthought, for policymakers.
2. The JLBC has not had time to assess the methodology of an estimate from the Arizona League of Cities and Towns that the legislation would cost state and local governments $180 million annually (GCI's initial conservative adjustment of the estimate yields a cost of at least $50 million annually).

A related issue is the distinction between TPT and use tax. TPT is collected by the seller. Use tax must be voluntarily reported and paid by the buyer. Use tax payment almost never

occurs. A University of Tennessee study estimated that in 2012 Arizona lost $708 million in unpaid use tax.

When a seller is deemed to have a physical presence, the seller must collect TPT (sales tax). DOR currently attributes nexus to on line sellers that have an affiliate presence through a related corporate entity that promotes or sells their product or a click-through nexus whereby a website in the states provides a click through to the remote seller. Most states have similar provisions but have done so through law rather than interpretation by their Dept. of Revenue—though in some states it is a combination (see South Dakota Supreme Court petition, p.11).

The best step forward for Arizona is the following:

1. Wait for the U.S. Supreme Court decision in *South Dakota v. Wayfair*.
    a. Regardless of who prevails, the state needs to codify existing DOR practices related to affiliate and click-through connections to the state as defining a nexus for TPT collection
    b. If South Dakota prevails, the state would likely be able to redefine nexus based on an amount of sales in the state, such as exceeding either $500,000 in sales or 25 percent of all sales. This would enable the state to force other out of state vendors to collect TPT as opposed to the voluntary and severely underpaid use tax. This step would follow the recommendation of the Multistate Tax Commission.
2. Explore how best in statute to deal with SaaS and what constitutes a taxable SaaS good and what constitutes a nontaxable SaaS service with a proper analysis of any revenue implications compared to current DOR practice.

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