

Taxation: Internet Media Commerce (I-media)  
By Mark R. Grupp, CPA, MST  
Director of Taxes, RealNetworks, Inc., Seattle, Washington

Summary: Internet media distribution platforms have created an emerging Internet Media Commerce industry (I-media). National guidance on related sales and use tax is needed to support the two most prevalent I-media models – subscription websites and digital downloads. There are currently no state laws specifically addressing the sales and use taxation of subscription websites. There is conflicting treatment among states relative to sales and use taxation of digital downloads.

Text

New Internet media distribution platforms while not immediately supplanting traditional platforms could serve to make the Internet the next great mass media for human communication. To this end, both the private and the public sector are currently working toward addressing the legal and economic challenges surrounding Internet media distribution. One of these challenges inevitably will be how public policy makers choose to tax Internet media commerce (“I-media”) created by Internet media distribution. This article seeks to highlight sales and use tax issues with respect to the two leading I-media venues - subscription websites and digital downloads.

As a precursor to an issues discussion, understanding the genesis of traditional and Internet media distribution provides a cornerstone toward any debate regarding Internet distribution platforms and taxation of the resulting commercial transactions.

To some degree the genesis of television and radio media is related to Guglielmo Marconi<sup>1</sup> who invented wireless radio wave transmissions in 1885. This wireless transmission became a mass broadcasting medium in 1920 when Westinghouse’s KDKA began regular broadcasts.<sup>2</sup> In 1923, the technologies for transmitting television over radio waves was being developed and by 1937 the British Broadcasting Corporation began the first regular, high-quality television broadcasting service.<sup>3</sup>

To avoid conflicting transmissions over the airwaves, the United States passed The 1927 Radio Act that created the Federal Radio Commission that in turn became the Federal Communications Commission (FCC) after passage of The 1934 Communications Act. The airwaves were considered to be a public resource and therefore governed by a public body. The governance was necessary so that no one commercial or political interest would gain control of the public airwaves and also so that frequencies could be assigned without conflict. This governance also had the effect of shaping how traditional media would be distributed.

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<sup>1</sup> Born April 25, 1874 - Died July 20, 1937

<sup>2</sup> PBS A Science Odyssey: Radio Transmission: Early Years – [www.pbs.org](http://www.pbs.org).

<sup>3</sup> It is useful to note that the mass media created a popular culture of information and entertainment shared by entire societies. Prior to mass media, culture was generally localized.

Television and radio media is distributed through a combination of Traditional Networks<sup>4</sup> and Affiliates. A typical Traditional Network affiliate receives a significant portion of its programming each day from the Network. The Traditional Network in exchange for a substantial majority of the national advertising inventory provides this programming, along with cash payments, to the affiliate during Network programs. The Traditional Network then sells this advertising time and retains the revenues so generated. The Network/Affiliate distribution model is partly the result of airwave regulation by the FCC. Under FCC regulations, multiple and foreign ownership of local broadcast licenses is restricted. This means that no one network can own all the FCC licenses required for national distribution and therefore affiliate relationships is utilized.

The Internet media distribution model instead of having its genesis in one-way radio waves has its genesis in a dynamic two-way Internet environment. This genesis provides significant contrast between to two distribution models. This contrast gives the Internet distribution model inherent commercial advantages that should foster related commerce and contribute to economic growth for the United States economy.

The Internet media distribution model contrasts from the traditional distribution model in terms of passivity. The traditional distribution model is systemically one-way. It is impossible to think of individuals building transmitters so that they can provide contemporaneous communication with the commercial transmitter. This one-way paradigm thus creates a passive user base that can basically turn the programming on or off.<sup>5</sup> On the other hand, the Internet distribution model is two-way which has the power to bring the users from passive viewers to active participants.

The Internet environment in addition to bring a level of active participation can also free media from the time and distance constraints currently endemic to the traditional media distribution model. Specifically, the Internet allows for time shifted viewing of stored events. Such time shifting can also be at the viewer's discretion with respect to on-demand multiple access availability of media. The Internet also does away with geographic constraints so that users worldwide can enjoy media generated continents apart.

Finally, the traditional model involves public airwaves that require a public solution to governance. One result of such public governance is that individual media distribution companies tend to be restricted in terms of geography. This means that tax policy as it applies to the distribution companies, generally affect one jurisdiction and do not necessarily require a national debate to ensure commerce is not impeded by tax policies.

In contrast, the Internet distribution model involves the Internet whose bandwidth is neither owned nor controlled by any one single public or private body. Any attempt to tax

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<sup>4</sup> Examples of Traditional Networks are NBC, ABC, CBS, Fox and Warner Brothers Network (WB Network) and United Paramount Networks (UPN).

<sup>5</sup> While digital cable TV does provide some level of interaction, the level of user interaction is somewhat primitive.

commerce related to Internet media distribution will inevitably affect more than one single geographic location. Accordingly, a broader public policy debate regarding I-media is required particularly given its potential positive impact on the United States economy.

The background having been laid out, the rest of this article examines the sales and use taxation issues surrounding subscription websites and digital downloads.

### Subscription Websites

The public policy goals with respect to taxation of subscription websites should be:

1. **Neutrality** – Any tax should seek to be neutral irrespective of the technology used for delivery whether it is satellite, cable, wireless, etc. It should also be neutral with respect to other similar forms of goods or services offered in the market place. With respect to subscription websites, it is anticipated that technology will make their delivery ubiquitous over many platforms including cell phones, personal digital assistants (PDA's), televisions and personal computers ("PC"). Neutrality issues arise for example when the stationary nature of televisions and PC's cause a different tax analysis for the same subscription website used on a cell phone or PDA which tend to be very mobile in use.
2. **Efficiency** – Any tax should be simple to administer and seek to minimize the compliance costs for businesses. Record keeping and administration may have special challenges with subscription websites. For example, privacy laws may actually prevent subscription website providers from obtaining the required information. And, even if such information is obtained, privacy laws may serve to complicate the release of information necessary for any jurisdiction to verify the tax collected upon audit.
3. **Certainty and simplicity** – Any tax should be predictable and consistent among jurisdictions to allow for rational economic decision-making. Having multiple treatments among states relative to both the tax and the tax base is counterproductive to the economy in general. Also, the overarching concern relative to "nexus" needs to be given some certainty. There currently seems to be no "bright line" test for websites and related goods and services.

The current tax laws relative to subscription websites are less than clear. One starting point for the direction of tax for subscription websites lies in a February 2001 report released by the Income Characterization General Mandate Technical Advisory Group ("TAG") to the Organization of Economic Cooperation and Development ("OECD"). That report defines subscription websites as

“The provider makes available to subscribers a web site featuring digital content, including information, music, video, games, and activities (whether or not developed or owned by the provider). Subscribers pay a

fixed periodic fee for access to the site. The principal value of the site to subscribers is interacting with the site while online as opposed to getting a product or services from the site.”

The report states through analysis that

“The Group [TAG] agrees that the subscription fee paid in this type of transactions would constitute a payment for services. As that payment is mainly for the interaction with the site for purposes of the personal enjoyment of the user and not for the provision of any service of a technical, managerial or consultancy nature, it would not, under the previously quoted definition of “technical fees”, fall under the alternative provisions covering these types of payments. The Group also agreed any payment to the owner of the copyright in the digital content that would be made by the provider for the right to display that content to its subscribers would constitute royalties.”

While the OECD is an international policy fostering organization, its insights can be useful for a United States sales and use tax discussion. To this point, the TAG report appears to be useful in that it could be used as support to establish that subscription website fees are payments for services as opposed to payments for intangible or tangible personal property. This apparent usefulness begins to fade as details of sales and use taxes on services are examined. As background, sales and use taxes are designed to apply to sales of tangible personal property, unless specifically exempted. But, the opposite holds true for services. That is they are not subject to sales tax unless specifically included.<sup>6</sup> Therefore, if subscription websites are characterized as services for state sales and use tax purposes, the application of any such taxes could widely vary.

For example, if states chose to tax subscription websites in the same vein as cable television services, the base of such tax could vary from state to state. As case in point, Indiana charges sales tax on cable television services<sup>7</sup> whereas Pennsylvania taxes only premium cable or pay television services.<sup>8</sup> Therefore, the same subscription website transaction could have a different tax base depending upon the state charging the tax.

Even more fundamental to the analysis would be whether or not any particular state had nexus to the subscription website fee. Again, characterizing the subscription website as a service poses a vexing question. Since the nexus for services are the place of performance, is the subscription website service being performed at the user’s computer or at the host’s computer? If it is performed at the host’s computer, then the service could not be subject to the sales tax regime of the user residing a state different from that of the host. On the other hand, if the service is said to have taken place at the user’s computer, sales tax would be collected only if the host had nexus in the user’s state. Then the nexus

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<sup>6</sup> Hellerstein and Hellerstein: State Taxation, Third Edition, Para. 15.01.

<sup>7</sup> Indiana Law section 6-2.5-4-11.

<sup>8</sup> Pa. Stat. Ann. 72 section 7201(m)

question itself raises the entire host of issues relative to Due Process and Commerce Clause<sup>9</sup> for remote sellers as per *Quill*<sup>10</sup>.

There are no Supreme Court cases directly addressing the constitutionality of a state sales and use tax on services performed for the benefit of those outside the state of taxation.<sup>11</sup> The Iowa State Supreme Court addressed the issue somewhat indirectly in *Lee Enterprises vs. The Iowa Department of Revenue*<sup>12</sup> where a print and broadcast media company asserted Commerce Clause protection from the state's sales service tax on advertising services where directed beyond the state's borders. Specifically, Lee Enterprises operated in the tri-state area of Davenport, Iowa directing its media circulation and broadcasts at citizens in Iowa, Illinois and Wisconsin. Lee contended in the case that Iowa's tax on the sales of advertising directed at customers in Illinois and Wisconsin in addition to Iowa violated the Commerce Clause prohibition against taxation of interstate commerce. The court recognized the underlying conflict before it in stating

“This conflict has constantly been raised before the United States Supreme Court in the past 150 years. Decisions sometimes appear in hopeless conflict, and the opinions defining the extent of this clause find many vigorous dissents. The delicate balance between federal and state authority in this field was recognized by Mr. Justice Holmes in *Superior Oil Co. v. State of Mississippi ex rel. Knox*, 280 U.S. 390, 395, 74 L.Ed. 504 , 505, 507 (1930), where he said: "The importance of the commerce clause to the Union of course is very great. But it also is important to prevent that clause being used to deprive the States of their lifeblood by a strained interpretation of facts. We may admit that this case is near the line." We must admit the same is true in the case before us.”

In holding that the Iowa tax was not in violation of the Commerce Clause the Lee court stated

“Of course, all interstate commerce is not per se immune from state taxation. In order for it to be exempt, it must be *shown* that the same revenue may be likewise taxed by another state to be classified as an undue burden thereon. If, then, it appears that the circulation or dissemination of the advertising purchased in Iowa, when printed, published or broadcast in Iowa, is not such a taxable event as to permit another state also to tax the revenue from such sale, then no undue burden on interstate commerce occurs. Appellees [Lee Enterprises] do not explain how such a tax could be levied or collected by the State of Illinois.”

So in an indirect way the court concluded that an in-state service directed towards out-of-state users cannot be taxed in the out of state jurisdiction barring nexus issues.

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<sup>9</sup> Section 8, Article I, of the United States Constitution

<sup>10</sup> *Quill* Corp. v. North Dakota, 504 U.S. 298 (1992)

<sup>11</sup> Hellerstein & Hellerstein: State Taxation, Third Edition, Para. 18.06

<sup>12</sup> 162 NW2d 730, 1968

This logic seemed to hold in opposition to attempts by Florida<sup>13</sup> and Massachusetts<sup>14</sup> in 1987 and 1990, respectively, to tax services performed outside the state but used by residents in those states. The Florida statute was directed at services “used” in Florida irrespective of where performance took place. The burden was placed on the out-of-state service provider to collect the tax. Similarly, the Massachusetts law was directed at taxing services provided to Massachusetts businesses by out-of-state providers.

Both state’s taxes were based on use tax reasoning in that the in-state users should be paying use tax on the services provided. However, the opposition to the statutes was strong particularly by the advertising industry in Florida. Advertisers, in conjunction with their clients, pulled ads from Florida television, radio, and print outlets to protest the imposition of the tax. Television screens went blank instead of receiving advertisements.<sup>15</sup> At the end of the day, Florida’s act was operational on July 1, 1987 and thereafter for approximately six months before it was repealed. Massachusetts’ act was effective March 6, 1991 and repealed two days later, retroactive to its effective date.

So as to the overall public policy goals stated at the beginning of this section, the goal of certainty and simplicity is hardly met under the current system. Specifically, there are no direct state tax laws aimed at subscription websites and therefore the states will be left on their own to develop laws within the context of their individual laws. In contrast, guidance from a national level will provide a certain and, hopefully, simple tax environment for subscription websites. This guidance can come through Congressional action early on or through judiciary action after years of conflicting litigation at the state and appellate levels.

It would seem that Congressional action would need to be mindful of delivery technologies and privacy concerns relative application. The current laws even though indirect would serve as a good starting point in that subscription websites could be considered services and therefore not subject to state sales and use tax either at all or unless the seller has substantial nexus with the taxing state. Even if taxed as a service, there would be inconsistency among the states as services are generally not subject to sales and use tax unless specifically mentioned in state statutes. It may therefore make good public policy to exempt subscription websites from all sales and use taxes until consistent treatment is garnered among the states. To do otherwise could impede a fledgling industry in which the United States currently leads.

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<sup>13</sup> The first, Senate Bill 777 was signed into law on April 23, 1987. It became Chapter 87-6, 1987 Fla. Laws 9 and was effective July 1, 1987. The second act, House Bill 1506, known as the “glitch bid” was signed into law on June 30, 1987. It became Chapter 87-101, 1987 Fla. Laws 842.

<sup>14</sup> Former Mass. Gen. L. ch. 64H § 2A

<sup>15</sup> Fee, Murphy, and Mortenson, 1310-2nd T.M., *Sales and Use Taxes: Services*. Within the *Multistate Tax Portfolio Series*

## Digital Downloads

Digital downloads provide yet another commerce model relative to I-media. The advantages to the customer of digitally distributed media via the Internet are the flexibility in acquiring song titles, the ability to store and manage volumes of tracks and the ability to access a very wide range of artists and musical tastes. The public policy regarding digital downloads are similar to those surrounding subscription websites but have specific issues relative to each concern.

1. Neutrality – Any tax should seek to be neutral with the true object that the user receives. In the case of digital downloads, the true object may be a service rather than tangible personal property. For example, music download subscription services on the Internet currently offer "limited access" downloads that restrict the ability of the consumer to transfer the files to other computers and that restrict the time of usage (e.g. 30 days). Thus, a subscription download service is more akin to an "access right" than to the permanent distribution of a product to an end user. Such access rights would appear to be services or intangible property rather than tangible property.
2. Efficiency – Like subscription websites, any tax should be easy to administer within the context of privacy issues related to the Internet. It would also be helpful if one tax base could apply. For example, how will the tax base apply to subscription music download services that also provide streamed Internet music? An analysis by state of the true object of such a transaction could prove conflicting and difficult to administer.
3. Certainty and simplicity – Any tax needs to be consistent in its application among the states so that economic certainty can be attained relative to the taxation of digital downloads. As discussed below, there currently exists conflict among states as to the treatment of digital downloads. Some states appear to recognize digital downloads as services or intangible property while others recognize them as tangible personal property.

When examining the current state of sales and use taxation relative to digital downloads the states have given consideration to how digital downloads will be taxed for sales and use tax purposes.

In March 2001, the Streamline Sales Tax Project (SSTP) digital products working group sent a survey to state tax administrators to find out how they are currently taxing digital products. Of the twenty-four states that responded, nine taxed digital goods, fourteen did

not and one is litigating the issue. Of the nine states that taxed the digital goods, one taxed them as services<sup>16</sup>, seven taxed them as tangible personal property<sup>17</sup> and one taxed them because they were not specifically exempted<sup>18</sup>. On the other hand, of the fourteen states that did not tax digital goods, nine did not tax them because they did not consider digital goods to be tangible personal property<sup>19</sup>.

Therefore, even though consideration has been given to the taxation of digital downloads, consensus has yet to come. So, until consensus is formed, players in digital download commerce will face an uncertain picture relative to sales and use tax collection irrespective of the on going nexus issues.

There appears to be two overarching issues when taxation of digital downloads are considered. One is that digital downloads appear to be electronically delivered cousins of their physical world counterparts such as compact disks in the case of music. The other is that digital downloads may have user rights differing from their physical counterparts. To the first issue, if the digital downloads are the duplicates of their physical counterparts then the method of delivery is the only differentiating feature. In this case it would seem counterintuitive to create separate taxing regimes for the same product depending only upon delivery method. To the second issue, digital downloads may not give users the same rights in the underlying copyrighted material as compared to the rights received with their physical counterparts. Digitally downloaded music for instance may not carry with it the right to transfer it to another user. More specifically, an owner of a CD can sell the CD to another person without copyright violation. The same CD in digital form may not carry with it the rights transfer digital file or a related physical file<sup>20</sup>.

This is therefore the vexing issue facing public policy makers. If digital goods carry with them the same rights as their physical counterparts then taxing them equivalently makes sense. If, in contrast, the digital goods carry lesser rights then taxing them equivalent to their physical counterparts may not make sense. In fact, digital goods with only limited rights could fall under a service analysis rather than a tangible property analysis as appears to be the case in nine of the states in the SSTP digital goods survey.

So, in seeking a neutral tax solution, consideration must be given to the fact that digital downloads are not necessarily the equivalent of their physical counterparts. This could challenge the notion that the laws taxing an apparent the physical counterpart should be directly applied to the digital download. This may prove inequitable to the user paying the tax. As case in point, a user may pay tax for a CD and have that CD in his or her music library for three years. The user then sells the CD at a CD exchange for credit or another CD. In the meantime, the user may have made a personal copy for his car stereo. On the other hand the same user subscribes to a download of the CD and has the download time out after 30 days with no ability to make a personal copy. Granted the tax

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<sup>16</sup> Connecticut

<sup>17</sup> Idaho, Indiana, Louisiana, Missouri, Texas, Utah and Washington

<sup>18</sup> South Dakota

<sup>19</sup> Arkansas, California, Georgia, Illinois, Kansas, Minnesota, New Jersey, Vermont and Wisconsin

<sup>20</sup> For example, digital music files could be burned onto a CD

base will be different in that the digital download price contemplates limited use but applying the same tax law would seem unfair. The digital download is temporary and in a public policy sense will not use transportation resources for delivery or landfill resources for disposal but yet the tax is the same?

Again, like subscription websites, it may be appropriate to exempt digital downloads from state sales and use taxes until all the issues can be vetted. In this regard, there needs to be a national debate on the consistent treatment among states as to how digital downloads will be taxed particularly those with limited user rights.