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Consuming the Benefits of Copyright: Multijurisdictional Sales Tax Complexity

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CONSUMING THE BENEFITS OF COPYRIGHT: MULTIJURISDICTIONAL SALES TAX COMPLEXITY

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INTRODUCTION

State governments have wide latitude in how they structure their sales taxes within the U.S. federal structure. That autonomy allows states to enact taxes that reflect the different political and economic factors that apply in their jurisdictions. That flexibility is good for states, but it is not always great for those doing business in interstate commerce. The costs associated with trying to comply with states' disparate laws impact business' bottom lines. At a macro level, those costs also serve as a drag on interstate commerce in conflict with the economic goals of the country as a union of states. That tension between state autonomy and economic efficiency is central to the field of state and local tax. Its impact is also widespread. This symposium contribution looks specifically at how this story plays out in the context of the creation and distribution of copyrighted works.

The variations in states' sales taxes are widespread, and sometimes amusing. For example, Twix may receive favorable tax treatment as compared to Snickers. Why? Because the former contains flour, so it seems more like food than candy.[2] Fast food restaurants sometimes pay tax on the napkins that they put in to-go bags but sometimes those purchases are exempt.[3] For a brief time, the Iowa Department of Revenue tried to tax pumpkins that were advertised as decorations rather than as food items.[4] The Ohio Supreme Court recently decided a case about whether a professional baseball team's purchase of bobbleheads was tax exempt—they were.[5]

Observers might find these oddities of state law amusing, but they evidence a complicated system of taxation. The "state sales tax" is not a monolith, but a patchwork of state laws, regulations, and judicial opinions that treat similar transactions differently, even among jurisdictions that ostensibly have the same tax. Those who sell in many states must determine when a tax applies, at what rate, and how to collect and remit it. That can become costly.

These burdens have not gone unnoticed by the Supreme Court, which has reserved itself the role of protecting interstate commerce from "undue burdens" as a

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[2] *See, e.g.*, ARK. CODE ANN. § 26–52–301 (2017) (imposing a sales tax on retailers' gross receipts, "except for food and food ingredients"); ARK. CODE ANN. § 26-52-103(18)(B) (2017) (defining the terms "food" and "food ingredients" to not include candy); ARK. CODE ANN. § 26-52-103(3)(B) (2017) (defining the term "candy" to "not include a preparation containing flour"). This particular quirk of state tax law has received attention outside of those engaged in the business of selling candy and tax professors who have a fondness for the sales tax. *See, e.g.*, South Dakota v. Wayfair, 138 S.Ct. 2080, 2103–04 (2018) (Roberts, C.J., dissenting); Austin Jenkins, *A Not-So-Sweet Tax on Candy*, NPR (May 31, 2010, 12:16 AM), https://www.npr.org/templates/story/story.php?storyId=127218749 [https://perma.cc/E92R-XPEX].

[3] *See, e.g.*, Jan Co. Cent., Inc. v. Comm'r, 544 N.E.2d 586, 589 (Mass. 1989) (denying a tax exemption for the purchase of napkins); Shamrock Foods Co. v. City of Phoenix, 757 P.2d 90, 93–94 (Ariz. 1988) (holding that the state consumption tax did not apply to sales of napkins and related products to restaurants); Celestial Food of Massapequa Corp. v. N.Y. Tax Comm'n, 473 N.E.2d 737, 738 (N.Y. 1984) (denying a tax exemption for the purchase of napkins).

[4] *See* John A. Swain, *The Pumpkin Tax*, 46 ST. TAX NOTES 363, 363, 365 (2007). That "pumpkin tax" was quickly repealed. *Pumpkin Tax in Iowa is Gone*, TAX FOUND. (Nov. 1, 2007), https://taxfoundation.org/pumpkin-tax-iowa-gone/ [https://perma.cc/A9Q9-FT35].

[5] Cincinnati Reds, L.L.C., v. Testa, No. 2017-0854, 2018 WL 6177334, at *2 (Ohio Nov. 21, 2018).

way of protecting the negative implications of the Commerce Clause.[6] Since the 1960s, the Court has fulfilled that function by preventing states from imposing tax-collection obligations on vendors that did not have physical presences within their boundaries.[7] That physical-presence rule originally served to protect mail-order vendors, and it may have protected many who transferred copyrighted works. If a person or business limited its physical operations to one state, but sold or licensed their works across the country, they could avoid broad tax-collection responsibilities.

That recently changed. The growth of online commerce, developments in technology, and the negative impacts of the physical presence rule on states caused the Supreme Court to overrule the physical presence rule in June of 2018.[8] The Court's change of course raised many questions for those who work on state and local tax matters.[9] It also raised questions for those in the copyright realm. If those engaged in transferring copyrighted works are newly subject to tax-collection obligations across the country, they will have to deal with significant challenges.

Unfortunately, transfers involving copyrighted works present many of the most difficult questions in this area of tax law. First, the legal characterization of those transactions—and therefore how they are taxed—is often unclear under state law. The purchase of a family photo, for example, can be considered a purchase of tangible property (generally taxable), of a digital good (often nontaxable), or of an intangible right (generally nontaxable). It could also be considered the purchase of a service, which again may or may not be taxable depending on the jurisdiction. State courts have ruled on either side of these issues in cases over the last decades.[10]

Transfers of copyrighted works or licenses to use them may also be exempt from tax under states' sales-tax exemptions for business consumption. Generally, sales taxes are designed to be imposed on final retail consumption.[11] Many transactions involving copyrighted works are sales or licenses to business consumers who will use the underlying work in their business or in producing another item for sale at retail. Theoretically, the original sale or license should be exempt from tax, even if it technically falls within the state's tax base as an original matter.[12] State laws are inconsistent on this point though. Up to forty percent of state's consumption tax bases include business consumption.[13] Determining how a state will view business purchases can therefore be complicated.

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[6] *See* BRANNON P. DENNING, BITTKER ON THE REGULATION OF INTERSTATE AND FOREIGN COMMERCE § 6.01 (2d. ed. 2018) (discussing the Court's assumed role in this area).

[7] Nat'l Bellas Hess v. Dep't of Revenue of Illinois, 386 U.S. 753, 753–54, 758–60 (1967).

[8] South Dakota v. Wayfair, Inc., 138 S.Ct. 2080, 2095–96 (2018).

[9] *See, e.g.*, Paige Jones, *Marketplace Taxation Is the New Post-*Wayfair *Frontier, Officials Say*, 89 ST. TAX NOTES 1294, 1295 (2018); Annette Nellen, *A* Wayfair *Whirlwind of Stakeholder Considerations—Part 1*, 90 ST. TAX NOTES 191 (2018); Darrien Shankse, David Gamage, & Adam Thimmesch, Wayfair*: Marketplaces and Foreign Vendors*, 90 ST. TAX NOTES 111, 113 (2018); Adam Thimmesch, Darien Shanske, & David Gamage, Wayfair*: Sales Tax Formalism and Income Tax Nexus*, 89 ST. TAX NOTES 975, 977 (2018); Adam Thimmesch, Darien Shanske, & David Gamage, Wayfair*: Substantial Nexus and Undue Burden*, 89 ST. TAX NOTES 447, 449–51 (2018).

[10] *See* discussion *infra* Section I.A.

[11] *See* JEROME R. HELLERSTEIN ET AL., STATE TAXATION ¶ 12.01 (3d ed. 2018).

[12] *See id.*

[13] *See id.*

This symposium contribution introduces these complexities with a view toward identifying the impacts of state consumption taxation on the production and distribution of creative works protected by federal copyright law. The lessons are particularly important for thinking about how states' laws can disparately impact small producers. Sales-tax compliance costs can be especially problematic for smaller commercial actors because many of those costs are fixed. That provides larger actors with economies that may tend to perpetuate the centralization of creativity. That problem could become especially pronounced following the Court's recent decision to expand state taxing power,[14] which may functionally require smaller creators to rely on centralized distribution systems for their work.[15]

The discussion in this essay evaluates these issues by providing a brief introduction to state consumption taxes and the difficulties that transfers of copyrighted works create under states' laws, with a focus on state cases involving transfers involving visual art. Part I provides background on the state consumption tax and two categories of issues that can arise for those involved in the transfer of copyrighted works. Part II then evaluates the Court's recent decision in *South Dakota v. Wayfair* and how it will likely expand the number of states that have authority to require tax collection by those selling their copyrighted works. Part III then discusses how those engaged in this type of business might seek to change the law or how they might change their business model in order to reduce the extent to which state taxes consume the benefits of federal copyright protection.

I. THE STATE CONSUMPTION TAX

Forty-five states currently impose consumption taxes, and they raise approximately $300 billion a year doing so.[16] Those taxes account for approximately one-third of all state tax collections.[17] Consumption taxation is also held in high regards among optimal tax theorists and certain politicians.[18] But states have never

[14] *See* South Dakota v. Wayfair, Inc., 138 S.Ct. 2080 (2018) (repealing the Court's long-standing physical-presence limitation on state taxing power).

[15] *See* discussion *infra* Section III.C (discussing the use of marketplace facilitators as a way of reducing compliance costs).

[16] U.S. CENSUS BUREAU, 2017 ANNUAL SURVEY OF STATE GOVERNMENT TAX COLLECTIONS DETAILED TABLE (2018), https://www2.census.gov/programs-surveys/stc/tables/2017/2017-stc-detailed.xlsx [https://perma.cc/63VK-B8AY]. Those taxes come in the form of complementary sales and use taxes, which work together to include in-state consumption in the tax base regardless of where a purchase technically occurs. *See* Adam B. Thimmesch, *Taxing Honesty*, 118 W. VA. L. REV. 147, 151–57 (2015) (discussing the difference between state sales and use taxes). For ease of discussion, the remainder of this essay will refer only to sales taxes or consumption taxes, generally.

[17] U.S. CENSUS BUREAU, *supra* note 16; *see also* CHERYL LEE ET AL., U.S. CENSUS BUREAU, STATE GOVERNMENT TAX COLLECTIONS SUMMARY REPORT: 2014 (2015), https://www.census.gov/content/dam/Census/library/publications/2015/econ/g14-stc.pdf [https://perma.cc/3MFL-TXB5].

[18] The academic debate regarding the merit of consumption taxes versus income taxes is long and storied. Joseph Bankman & David Weisbach, *The Superiority of an Ideal Consumption Tax Over an Ideal Income Tax*, 58 STAN. L. REV. 1413, 1414 (2006). The debates have focused on which tax is optimal, in its "ideal" form, and more recently on how tax systems should be designed given practical and political constraints on achieving any ideal tax. *See, e.g.*, David Gamage, *The Case for Taxing (All of) Labor Income, Consumption, Capital Income, and Wealth*, 68 TAX L. REV. 355 (2015); Edward J. McCaffery,

implemented consumption taxes that comport with theorists' normative ideal—a uniform tax on retail consumption.[19] States' taxes are under and over inclusive by that metric. They do not reach *all* retail consumption, and they inappropriately apply to a significant amount of business (*i.e.*, non-retail) consumption.

These departures from the normative ideal create two big questions for those engaged in business: (1) determining whether the goods or services that they sell fall within a state's tax base, and (2) determining whether the state has any applicable tax exemptions for business-to-business sales. These issues are discussed below.

A. The Consumption Tax Base

State consumption taxes have traditionally applied to the transfer of tangible personal property and to some services,[20] which is not surprising given their 1930s origin.[21] But the economy has developed since the 1930s, and transfers of intangible property and of services have become a larger part of the overall market. States have struggled to keep up to date for political, economic, and conceptual reasons.

Modernizing the tax base can be difficult politically because tax-base extensions can be perceived as "raising taxes," which is generally unpopular. Take for example, states' recent efforts to expand their sales taxes to digital services like Netflix.[22] The consumption of entertainment goods, whether via physical disc or streaming bits, would fall within any normatively "pure" consumption tax base. And yet, when states have modified their state laws to account for this change in consumption mode, taxpayers are far from happy with that base broadening.[23] Individuals seem to quite rationally preference their pocket books over a conceptually-sound tax base, and politicians seem to be quite happy to leverage that self-interest into votes.

Extending the tax base can also be difficult as an economic matter. States must always be wary of competition from other states, particularly neighboring states. If a state expands its tax base more broadly than another, it might find that its residents simply go across the border to make their purchases. That will not always be

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A New Understanding of Tax, 103 MICH. L. REV. 807, 810–11 (2005); George R. Zodrow & Charles E. McClure, Jr., *Implementing Direct Consumption Taxes in Developing Countries*, 46 TAX L. REV. 405, 407–08 (1991).

[19] HELLERSTEIN, *supra* note 11 (recognizing that "no state has adopted a theoretically pure retail sales tax").

[20] *Id.* at ¶ 12.04[1].

[21] *Id.* at ¶ 12.02,

[22] *See* Elaine S. Povich, *Time to Tax Netflix? Some Cities, and a State, Think So*, PEW TRUSTS (Jan. 3, 2017), https://www.pewtrusts.org/en/research-and-analysis/blogs/stateline/2017/01/03/time-to-tax-netflix-some-cities-and-a-state-think-so [https://perma.cc/P54B-MPKN].

[23] *See* Capital News Serv., *House Committee Kills 'Netflix Tax' Ending Possibility of Taxing Streaming Services in Virginia*, WTKR.COM (Jan. 29, 2018, 6:55 PM), https://wtkr.com/2018/01/29/house-committee-kills-netflix-tax-ending-possibility-of-taxing-streaming-services-in-virginia/ [https://perma.cc/CEH6-LYNM]; Kelly Phillips Erb, *Chicago's 'Cloud Tax' on Streaming Services Like Netflix Survives Legal Challenge*, FORBES (May 29, 2018, 1:37 PM), https://www.forbes.com/sites/kellyphillipserb/2018/05/29/chicagos-cloud-tax-on-streaming-services-like-netflix-survives-legal-challenge/#5140c3df60d6 [https://perma.cc/86CT-GN2V]; Povich, *supra* note 22.

possible, of course, but it is a source of concern especially when major population centers fall close to state boundaries.[24]

As if these political and economic challenges were not enough, extending the sales tax to more types of consumption also raises difficult conceptual questions. To start, it can be difficult to determine where the consumption of services or intangible goods occurs—and therefore to determine in which state a transaction should be subject to tax. Take, for example, the purchase of legal services. If a person in Kentucky hires an Ohio lawyer, which state would tax the legal fees? Does the consumption occur in Ohio where the services are performed, or does that consumption occur where the client "uses" the legal services? If the latter, how is that determination made? Imagine that the client hired the lawyer to provide advice on a labor matter that affected the client's business locations in many states. Should all of those states tax a portion of the purchase price? Only one? Issues like these naturally present themselves when the sales tax is extended beyond transfers of physical goods.

The result of these political, economic, and conceptual challenges is that states are often stuck with antiquated laws that provide for disparate treatment regarding the taxation of tangible goods, digital goods, intangibles, and services.[25] State revenue authorities are left with the task of applying those laws to transactions that do not fall neatly within those categories. The results are not always pretty.

Consider, for example, how states tax general retail photographers. Photography itself is a service, but the resulting photographs are goods. Those goods can be transferred either in physical form or in digital form, and digital photos can be transferred through physical (e.g., flash drive, CD-ROM) or digital means (e.g. email, web download). A photographer might also grant its customer the right to reproduce the photos. The same business arrangement can thus include the transfer of a service, a tangible good, an intangible good, and an intangible right. So how will it be taxed? It depends on state law and administrative practice.

Looking at just a few states provides a nice introduction to the disparate approaches taken by states. For example, Florida generally requires photographers to collect tax on their whole fee.[26] However, if a photographer charges a sitting fee,

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[24] The "border effect" has long been recognized in the economic literature. *See* William F. Fox, *Tax Structure and the Location of Economic Activity Along State Borders*, 39 NAT'L TAX J. 387 (1986); Mehmet S. Tosum & Mark L. Skidmore, *Cross-Border Shopping and the Sales Tax: A Reexamination of Food Purchases in West Virginia*, 7 B.E. J. ECON. ANALYSIS & POL'Y 1935 (2007), https://doi.org/10.2202/1935-1682.1877 [https://perma.cc/VXM3-T4FP].

[25] Twenty-four states have adopted the Streamlined Sales and Use Tax Agreement, which provides standard definitions for digital products, but that provides only limited help to those selling digital goods across the country. *See FAQs – General Information about Streamlined*, STREAMLINEDSALESTAX.ORG, https://www.streamlinedsalestax.org/Shared-Pages/faqs/faqs—about-streamlined [https://perma.cc/3ZRX-LQCM]; STREAMLINED SALES AND USE TAX AGREEMENT §§ 332–333 (2018) https://www.streamlinedsalestax.org/docs/default-source/agreement/ssuta/ssuta-as-amended-2018-05-03.pdf [https://perma.cc/5EEZ-4J63]. States have adopted different positions regarding whether, and the extent to which, digital goods are actually taxable, and those positions are spread between state statutes, regulations, and administrative guidance. *See* Catherine Chen, Note, *Taxation of Digital Goods and Services*, 70 N.Y.U. ANN. SURV. AM. L. 421, 448–55 (2015); Paul Jones, *Digital Transactions Remain a Tax Enigma, Experts Say*, 86 ST. TAX NOTES 615 (2017).

[26] FLA. ADMIN. CODE ANN. r. 12A-1.041(1) (2016).

but does not transfer any tangible personal property to the customer, no tax is owed.[27] Oklahoma makes it simpler by just taxing the photographs and the sitting fee as a service.[28] Iowa adopted that approach starting in 2018,[29] but before that, the state took the same approach as Florida.[30] Alabama taxes the transfer of photos as a sale of tangible personal property, even if the photographs are transferred digitally.[31] That makes sense as a matter of tax policy, but it involves a rather odd interpretation of the term "tangible." And despite that base-broadening interpretation, Alabama also exempts sitting fees from tax if they are separately stated.[32] Go figure.

California has a 33-page document that provides guidance on the application of its sales tax to those engaged in photography, photo finishing, or film processing.[33] The state generally taxes the entire charge associated with the creation and transfer of a photograph sold for noncommercial use.[34] If, however, the photographer provides the picture only digitally (via email or direct download), the charges are tax exempt.[35] If she loads the digital photo on a flash drive, the transaction is taxable again.[36]

These complications apply equally to those engaged in providing commercial artwork and to those operating in the retail space. A commercial artist may create an image at the request of a business customer, and she may transfer a physical copy of the image for the customer's review or use in its production process.[37] If the customer likes the art, she may pay for the right to reproduce the image. How will that type of transaction be taxed? Again, the artist provided a service, tangible personal property, and maybe an intangible right. Courts across the country have had difficulty with how to apply their taxes to that type of transaction.

In one prominent case, the Court of Appeals for the District of Columbia addressed this issue in the context of the transfer of comic strips via fiber matrices.[38] The court in that case decided that the transfer of the mats was actually a nontaxable service based on a statutory exemption for service transactions that involved an

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[27] *Id.* at r. 12A-1.041(4). Florida is not the only state that takes this approach. *See, e.g.*, MAINE REVENUE SERV., SALES, FUEL & SPECIAL TAX DIVISION INSTRUCTIONAL BULLETIN NO. 3 (2016).

[28] OKLA. ADMIN. COD E § 710:65-19-260 (2019).

[29] IOWA CODE § 423.2(5), (6)(bo)–(bp) (2018).

[30] IOWA DEP'T OF REVENUE, IOWA TAX REFORM GUIDANCE: PHOTOGRAPHY AND RETOUCHING SERVICES (2018), https://tax.iowa.gov/sites/files/idr/documents/TaxReformGuidance_Photography%20and%20Retouching%20Services.pdf [https://perma.cc/9HTZ-JYHL].

[31] ALA. ADMIN. CODE r. 810-6-1.119 (2017); *see also* FlipFlopFoto v. Ala. Dep't of Revenue., No. S. 05-1240 (Dep't Revenue. Admin. L. Div. Apr. 30, 2007).

[32] ALA. ADMIN. CODE r. 810-6-1.119 (2017).

[33] CAL. DEP'T OF TAX AND FEE ADMIN., PHOTOGRAPHERS, PHOTO FINISHERS, AND FILM PROCESSING LABORATORIES, (2018), https://www.cdtfa.ca.gov/formspubs/pub68.pdf [https://perma.cc/M8DL-XNFK].

[34] CAL. CODE REGS. tit. 18, § 1528.

[35] CAL. DEP'T OF TAX AND FEE ADMIN., *supra* note 33, at 2, 5.

[36] *Id.*

[37] The following discussion assumes that the subject art is not a work made for hire that results in copyright being vested in the "customer" in the first instance. HOWARD B. ABRAMS & TYLER T. OCHOA, 1 THE LAW OF COPYRIGHT § 4.1 (2018) (discussing works made for hire). That would represent a clear "sale" of services by the artist.

[38] Washington-Times Herald v. District of Columbia, 213 F.2d 23, 23 (D.C. Cir. 1954).

"inconsequential" transfer of tangible personal property.[39] What the court did not address was why it felt that the transaction involved a service at all. The newspaper did not contract with the artists, but with the distributer that owned the works.[40] It seems pretty clear that the newspaper did not buy the artist's services, but that it purchased the right to reproduce the comics and maybe leased or purchased the mats as well. Nevertheless, the court characterized the transaction to fit within a particular rule that got it the "right" answer.

The Supreme Court of California evaluated a similar case very differently in 2001. That case, *Preston v. State Board of Equalization*, involved the question of whether the states' sales tax would apply to various transfers of artwork for use in products like children's books and on stamps.[41] The artist transferred to her clients both a right to use her work and a tangible copy of the art that the clients could use to make the necessary images.[42] Her clients returned the physical artwork when they were done making the copies.[43] On those facts, the Supreme Court of California determined that the taxpayer had engaged in taxable transfers of the physical artwork, but that she had also transferred an intangible right to reproduce her work.[44] The latter portion of the fee was nontaxable under a California statute that excluded from tax amounts that were charged for intangible personal property under a "technology transfer agreement."[45] It split the artist's fee into an amount paid for the physical work and an amount paid for the intangible right.[46]

The Supreme Court of Colorado decided not to bifurcate similar transactions in a 2003 case involving the payment of royalties to artists by a greeting card manufacturer.[47] Like in *Preston*, that case involved the sale of a copyright license along with a temporary transfer of the subject artwork on a tangible medium.[48] The Colorado Court disagreed with the *Preston* court's characterization of the transactions as transfers of tangible artwork and instead found them to be transfers of the intangible right.[49] The court found it important that the purchaser did not acquire the right to resell the physical artwork and that it paid royalties rather than a lump-sum price.[50]

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[39] *Id.* at 24. The property was considered inconsequential if its value was less than 10% of the amount charged for services. *Id.*

[40] *Id.*

[41] Preston v. St. Bd. of Equal., 19 P.3d 1148, 1153–54 (2001).

[42] *Id.* at 1153.

[43] *Id.* at 1153–54.

[44] *Id.* at 1156–58.

[45] *Id.* at 1160–61, 1165 (citing CAL. REV. & TAX CODE § 6011(c)(10)(A) (2003).

[46] *Id.* at 1168.

[47] City of Boulder v. Leanin' Tree, Inc., 72 P.3d 361, 361–62, 366–67 (Colo. 2003).

[48] *Id.* at 362, 364–65.

[49] *Id.* at 362, 364–65, 368.

[50] *Id.* at 362–65. Transfers involving motion pictures have resulted in similar difficulties for states, licensors, and courts. *See, e.g.*, Cinemark USA, Inc. v. Seest, 190 P.3d 793, 795–97 (Colo. App. 2008); Columbia Pictures Indus. v. Tax Comm'r of Conn., 410 A.2d 457, 457, 461 (Conn. 1979) (construing license of film as a taxable license of tangible personal property rather than as a license of the intangible copyright); United Artists Corp. v. Taylor, 7 N.E.2d 254, 255–56 (N.Y. 1937); Crescent Amusement Co. v. Carson, 213 S.W.2d 27, 27–29 (Tenn. 1948).

Over time, states have come up with a variety of tests for making these distinctions. Some states attempt to divine the underlying intent of the party making the sale. They ask whether the "true object" or "dominant purpose" of the transaction was to transfer a tangible good, an intangible right, or a service.[51] Some attempt to compare the value of the ingredient parts, like in *Washington Times-Herald*.[52] Regardless of the particular test adopted in a state, the difficulties presented for those engaged in this area of business are manifest. State law may be clear or unclear, but it will almost certainly be complicated. Determining the applicability of state consumption taxes to these types of transactions can therefore be costly.

B. Consumption Tax Exemptions

The second source of complexity for those engaged in the transfer of copyrighted works is uncertainty regarding whether they might be protected from tax by an applicable sales-tax exemption. As noted above, the sales tax should only apply to final retail consumption, but many transactions involving copyrighted works involve *business* consumption. Those purchases should be exempted from tax to avoid "tax pyramiding," or the imposition of sales tax on sales tax.[53]

Imagine, for example, an art studio that purchases a $1000 desk and has to pay a 5% sales tax on that good. It will pay $50 of tax on its purchase. If that entire $50 tax cost is passed on to the studio's consumers, those customers will end up paying a total of $52.50 of sales tax.[54] That more than doubles the tax that would be collected if business inputs were exempt and represents an additional $2.50 of sales tax imposed just on sales tax.[55] That tax increase is not only hidden to consumers, but it involves the imposition of tax on the tax, and it will differentially impact households depending on what mix of items they purchase.[56] For these reasons, the imposition of tax at intermediate steps of the production process is roundly criticized as a normative matter.[57] Unfortunately, though, the principle is observed in the breach in practice as states routinely fail to exempt business inputs from taxation. This is so

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[51] HELLERSTEIN, *supra* note 11, at ¶ 12.08[1].

[52] *Id.* at ¶ 12.08[1][a].

[53] *See* RICHARD CLINE ET AL., COUNCIL ON STATE TAXATION, SALES TAXATION OF BUSINESS INPUTS: EXISTING TAX DISTORTIONS AND THE CONSEQUENCES OF EXTENDING THE SALES TAX TO BUSINESS SERVICES 1 (2005), http://www.ncsl.org/documents/standcomm/sccomfc/Business-Inputs-Study.pdf [https://perma.cc/W27M-PQMQ].

[54] The customer would pay 5% of sales tax on the $1000 "desk cost" and 5% sales tax on the $50 "tax cost" that is ultimately incorporated into the price of the art. That would result in a total tax of $52.50 (5% x $1050 = $52.50).

[55] The tax on the sales tax is 5% of the $50 of tax, or $2.50.

[56] *See* Kirk J. Stark, *The Uneasy Case for Extending the Sales Tax to Services*, 30 FLA. ST. U. L. REV. 435, 457 (2003).

[57] *See, e.g.*, HELLERSTEIN, *supra* note 11, at ¶ 12.01; Michele E. Hendrix & George R. Zodrow, *Sales Taxation of Services: An Economic Perspective*, 30 FLA. ST. U. L. REV. 411, 414–17 (2003) (discussing the arguments for exempting business inputs from consumption taxation); Stark, *supra* note 18, at 456–58 (discussing the problems with tax pyramiding).

prevalent that business inputs have been estimated as comprising approximately 40% of the sales-tax base across the country.[58]

Sales taxation on business inputs comes in many forms. Again, in principle, any purchase by a business leads to costs that are included in the price for its products.[59] That is true whether the purchased good is, or becomes a part of, the ultimate consumer good or whether it merely facilitates that transaction. Just as the art studio's cost for a desk will ultimately be incorporated into the price of the goods that it sells to customers, so too will the businesses' costs of containers, cleaning agents, and marketing materials.[60] Unfortunately, not all of these business inputs are exempt under state law.

The most straightforward exemption for business inputs is the exemption of "sales for resale." That exemption applies as it sounds. It applies when a buyer purchases an item to resell to its own customers (e.g., when Best Buy purchases a television for inventory or when your local grocery store purchases a loaf of bread).[61] The sale-for-resale exemption is tremendously significant and is necessary to avoid tax pyramiding on retail items.

Exemptions are similarly required for the items that are used to create retail goods, like wood that is fashioned into a desk or ink that is incorporated into a pen.[62] Those items are simple business inputs and their cost will be incorporated into the price that the manufacturer charges to its consumers. States generally provide exemptions for items used in manufacturing or production to some degree,[63] but states are less uniform regarding the breadth of those exemptions, especially when the inputs do not become component parts of the ultimate retail product. Take, for example, the cost of cleaning agents for a manufacturer's equipment. That cost is a business input, but the cleaning agents do not become a part of the product that is sold to consumers. The availability of a state tax exemption for that type of cost varies from state to state.[64]

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[58] Robert Cline et al., *Sales Taxation of Business Inputs: Existing Tax Distortions and the Consequences of Extending the Sales Tax to Business Services*, 35 ST. TAX NOTES 457, 458 (2005); Raymond J. Ring, Jr., *The Proportion of Consumers' and Producers' Goods in the General Sales Tax*, 42 NAT'L TAX J. 167, 175 (1989).

[59] Of course, the extent to which the taxation of business inputs results in tax pyramiding would change depending on the extent to which that tax is actually passed on to consumers in the form of higher taxes, but these examples assume 100% pass on for purposes of simplicity. The extent to which the tax is actually passed on to consumers will depend on many factors, including the elasticity of demand for particular products.

[60] This is not to say that *all* business consumption need necessarily be exempt from tax. If, for example, the business will make retail sales that are exempt from tax, it merits further consideration of whether its inputs should be exempt from tax. The issue in that case is not one of tax pyramiding, but of whether the end consumer should be spared the burden of passed on tax imposed at upper levels in the distribution chain. It may be the case that exemptions are warranted up the chain to reduce the price paid by the ultimate consumer, but it may also be the case that states are not so worried about those costs being imposed.

[61] *See* HELLERSTEIN, *supra* note 11, at ¶ 14.02 (discussing this exemption in detail).

[62] *See id.* at ¶ 14.03.

[63] *Id.* at ¶ 14.03[1][a] ("The state retail sales tax statutes generally exclude or exempt purchases of property for use as an ingredient or component part of tangible personal property to be manufactured or fabricated for sale.").

[64] *Id.* at ¶ 14.04.

The cases on business consumption are some of the more interesting in state tax. We see that sausage casings are treated differently than bourbon barrels.[65] We see that cooking oil used to fry chicken may be exempt, at least to the extent that it seeps into the final product and is not discarded as waste.[66] One recent case involved the application of state sales tax to promotional items purchased by the Cincinnati Reds.[67] Like many sports teams, the Cincinnati Reds use a variety of promotions to drive attendance at its games. It gives away merchandise like t-shirts, photographs, baseball cards, and even bobble heads.[68] This practice recently gave rise to a dispute between the team and the Ohio Department of Taxation.[69] The crux of the question: Were these items tax exempt to the baseball club as business inputs or were they taxable because the team did not resell them?[70] (The team did not list a charge for these promotional items that was separate from the ticket charge).[71] The Ohio Supreme Court recently determined that the items were indeed exempt.[72] That's a win for the baseball club and for tax theory.

Similar cases have arisen regarding the taxation of items like the toys put into Happy Meals at McDonalds, the napkins put into takeout bags at restaurants, and the toiletries provided by hotels.[73] There is even an entire series of cases on that taxability of containers and items like the wood pallets that businesses use to ship or receive products.[74] In each of these situations, the item being purchased is a business input and, yet, the question is whether the purchase is exempt under state law. Theory

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[65] *Compare* Am. Stores Packaging Co. v. Peters, 277 N.W.2d 544, 545, 548 (Neb. 1979) (sausage casings), *with* Am. Distilling Co. v. Dep't of Revenue of Ill., 368 N.E.2d 541, 542–44 (Ill. App. Ct. 1977) (bourbon barrels). Cases evaluating when production or manufacturing exemptions apply arise in many different areas of commerce. *See, e.g.*, *In re* Sprint Commc'ns Co., 101 P.3d 1239, 1241, 1244 (Kan. 2004) (telecommunications); Dart Indus. v. Clark, 696 A.2d 306, 307, 309–11 (R.I. 1997) (plastic products); Burlington Elec. Dep't v. Vt. Dep't of Taxes, 576 A.2d 450, 451–53 (Vt. 1990) (production of electricity); Pacificorp, Inc. v. Dep't of Revenue of Wyo., 401 P.3d 905, 907, 914 (Wyo. 2017) (same); Combs v. Home & Garden Party, Ltd., No. 03-09-00637-CV, 2010 WL 4367054 at *3–5 (Tex. App. Nov. 3, 2010) (home decorating products).

[66] Al-Tom Inv., Inc. v. Dir. of Revenue, 774 S.W.2d 131, 131, 134–35 (Mo. 1989).

[67] Cincinnati Reds, L.L.C., v. Testa, No. 2017-0854, 2018 WL 6177334, at *2 (Ohio Nov. 21, 2018).

[68] *Id.*

[69] *Id.*

[70] *Id.*

[71] *Id.* at *3.

[72] *Id.* at *2. Lest you think this issue is unique to Ohio, it has been litigated by baseball clubs in other states as well. *See, e.g.*, Minn. Twins P'ship v. Comm'r of Revenue, 587 N.W.2d 287, 288 (Minn. 1998); Kan. City Royals v. Dir. of Revenue, 32 S.W.3d 560, 561, 563–64 (Mo. 2000); Wis. Dep't of Revenue v. Milwaukee Brewers Baseball Club, 331 N.W.2d 383, 383–85 (Wisc. 1983).

[73] *See* McDonald's Rests. of Mass., Inc. v. Comm'r of Revenue, No. C262528, 2005 WL 941510, *5, *12 (Mass. App. Tax Bd. Apr. 22, 2005) (toys used in Happy Meals); State Dep't of Revenue v. Kelly's Food Concepts of Ala., LLP, 157 So. 3d 944, 945, 949–51 (Ala. Ct. Civ. App. 2014) (disposable items sold to fast food restaurants); Celestial Food of Massapequa Corp. v. N.Y. State Tax Comm'n, 473 N.E.2d 737, 737–38 (N.Y 1984) (paper and plastic items purchased by fast food restaurant); DTWC Corp. v. Combs, 400 S.W.3d 149, 151, 156 (Tex. Ct. App. 2013) (hotel consumables); Adamar of N.J. v. Dir., Div. of Taxation, 17 N.J. Tax 80, 82, 95 (N.J. Tax Ct. 1997) (hotel consumables).

[74] *E.g.*, R.R. Donnelley & Sons Co. v. Ind. Dep't of Revenue, 41 NE.3d 1053, 1056–57 (Ind. Tax 2015); Brambles Indus. v. Dir. of Rev., 981 S.W.2d 568, 569 (Mo. 1998); General Mills, Inc. v. Limbach, 520 N.E.2d 218, 219 (Ohio 1988) (involving packaging materials); *see also* HELLERSTEIN, *supra* note 11, at ¶ 14.06.

is of little practical use in resolving these disputes. Only a state-by-state analysis of statutory, regulatory, and judicial guidance will suffice.

These issues all affect those involved in the transfer of copyrighted works—both when they sell goods and when they make purchases. For example, an artist may sell artwork to a business to use in its packaging or promotions. Is that a sale for resale? Is it a sale to a manufacturer? Perhaps, but the purchaser does not actually incorporate the physical version of the subject art into the products that it sells. At best, the business purchaser will sell a copy of the work. On those conditions, it is not entirely clear whether states' exemptions for manufacturing or production will apply. Cases have come down on both sides of that issue.[75]

This same conceptual issue impacts artists when they make purchases of their own. Artists purchase a wide range of inputs, including paints, brushes, office supplies, cameras, film, computer equipment, or office furniture. States may or may not exempt those purchases under their business exemptions even though they should. Nevada regulations specifically note that commercial artists must pay sales tax on their purchases of such items.[76] In contrast, Idaho exempts items that are "directly incorporated" into artwork.[77] The New Jersey Tax Court has denied a baby photographer an exemption for its film purchases.[78] Massachusetts has allowed an exemption for film that is consumed in the development process, but has denied exemptions for purchases of background materials, props, and backdrops.[79] The variations are again numerous.

Ultimately, this symposium contribution cannot explore each of these unique state laws or provide guidance on the wide variety of state approaches. What is clear though, is: (1) that business consumption is subject to tax in many situations; and (2) that it is not clear when states' exemptions will apply even when transactions

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[75] *Compare* Standard Packaging Co. v. Comm'r of Revenue, 288 N.W.2d 234, 235, 239 (Minn. 1979) (exempt), *with* Kingsport Publ'g Corp. v. Olsen, 667 S.W.2d 745, 746–47 (Tenn. 1984) (not exempt). Often times, the form of a transaction is critically important. Iowa's Administrative rules, for example, provide that charges for "finished art" are taxable. Finished art includes art to be used in advertising and in the creation of printed materials for other purposes. IOWA ADMIN. CODE r. 701-18.27(4) (2019). In contrast, charges for "preliminary art" are exempt unless incorporated into finished art. *Id.* "Preliminary art" includes "roughs, visualizations, comprehensives and layouts prepared for approval of the clients." *Id.* Other states follow a similar approach. *See, e.g.*, CAL. CODE REGS. tit. 18 §§ 1540(b), 1541(d), 1543(b) (differentiating between preliminary art and final art for purposes of the state's sales tax);; MINN. R. 8130.8800, subpt. 1 (2019); WIS. ADMIN. CODE TAX § 11.70(1)-(3) (2018); ME. REVENUE SERV. SALES, FUEL & SPECIAL TAX DIV., INSTRUCTIONAL BULLETIN NO. 38: ADVERTISING AGENCIES AND GRAPHIC DESIGNERS, https://www.maine.gov/revenue/salesuse/Bull38.pdf [https://perma.cc/Q59B-WAK6].

[76] NEV. ADMIN. CODE § 372.227 (2018).

[77] IDAHO ADMIN. CODE r. 35.01.02.055 (2018); *cf.* ALA. ADMIN. CODE r. 810-6-1-.119(2), (3) (2018) (exempting items which become a "physical part" of the artwork").

[78] Hosp. Portrait Service Co. v. Taxation Div. Dir., 6 N.J. Tax 305, 307–08, 315–16 (N.J. Tax Ct. 1983).

[79] MASS. DEP'T OF REVENUE, DIRECTIVE NO. 88-9: FILM PURCHASES; MATERIAL CONSUMED AND USED IN INDUSTRIAL PLANT (1988), https://www.mass.gov/directive/directive-88-9-film-purchases-material-consumed-and-used-in-industrial-plant [https://perma.cc/VAZ4-A7ZA]; MASS. DEP'T OF REVENUE, MASS. LETTER RUL. NO. 89-7: CHEMICALS USED IN PHOTOPROCESSING (1989), https://www.mass.gov/letter-ruling/letter-ruling-89-7-chemicals-used-in-photoprocessing [https://perma.cc/3N5E-6E4A].

"should be" exempt as a matter of theory. Those engaged in creating works must be wary of state laws, research the laws that apply in the states where they do business, and adjust their practices and financial expectations accordingly.

II. COPYRIGHT TRANSFERORS AS TAX COLLECTION AGENTS

The tax complexities introduced above are problematic from many perspectives, but they may be largely manageable for businesses that operate in only a limited number of states. Learning complex rules takes time, but it is a part of doing business. The difficulties presented above become more problematic, however, where businesses are subjected to the rules of many different taxing jurisdictions. Tax compliance costs can rise quickly in those situations and can even become prohibitive. This is especially true in the United States, where even local jurisdictions have sales-tax authority.[80] Concern over these multi-jurisdictional costs has actually spawned an entire body of law regarding the scope of states' taxing power over vendors physically located in other states.

Any discussion of state taxing power must begin with the Tenth Amendment of the U.S. Constitution, which provides that "[t]he powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people."[81] That provision ensures that states have significant autonomy with regard to the structure of their consumption taxes. That autonomy is not complete though. Congress can restrict states' taxing powers by using its affirmative power to regulate interstate commerce under the Commerce Clause.[82] The Supreme Court also protects the negative implications of that affirmative power by prohibiting state laws that discriminate against, or unduly burden, interstate commerce.[83] That so-called negative or dormant Commerce Clause thus restricts state power even where Congress has not affirmatively acted to do so.

As applied to state taxes, the Supreme Court has ruled that the dormant Commerce Clause prevents states from imposing sales taxes that discriminate against interstate commerce and from imposing sales-tax collection obligations on vendors that do not have a "substantial nexus" with the state.[84] The Court has interpreted that substantial-nexus requirement very favorably for vendors since the 1960s, construing it to be met only if vendors have a physical presence within the taxing state.[85] That

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[80] The number of total jurisdictions is difficult to determine with precision, but is generally accepted to be just shy of 10,000. Glenn Kessler, *McConnell's Claim that There Are 'Nearly 10,000' Tax Codes Nationwide*, WASH. POST (Apr. 29, 2013), https://www.washingtonpost.com/blogs/fact-checker/post/mcconnells-claim-that-there-are-nearly-10000-tax-codes-nationwide/2013/04/26/a6b3bef4-aeaa-11e2-a986-eec837b1888b_blog.html [https://perma.cc/E6ES-AFQW]; Katherine Loughead, *Growing Number of State Sales Tax Jurisdictions Makes* South Dakota v. Wayfair *that Much More Imperative*, (Apr. 17, 2018), https://taxfoundation.org/growing-number-state-sales-tax-jurisdictions-makes-south-dakota-v-wayfair-much-imperative/ [https://perma.cc/S9X2-M8TV].

[81] U.S. CONST. amend. X.

[82] U.S. CONST., art. I, § 8, cl. 3 (granting Congress the power to "[t]o regulate commerce with foreign nations, and among the several states").

[83] DENNING, *supra* note 6, at § 6.01.

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

[85] National Bellas Hess, Inc. v. Dep't of Revenue of Ill., 386 U.S. 753, 757–59 (1967), *overruled by* South Dakota v. Wayfair, Inc., 138 S. Ct. 2080, 2094 (2018).

physical-presence safe harbor has operated to prevent states from imposing tax-collection obligations on vendors who merely sold into the state from afar, whether via catalogue, television, or the internet. Unfortunately for vendors, the physical-presence rule is no more. On June 21, 2018, the Court repealed the physical presence rule in *South Dakota v. Wayfair*.[86] With that decision, a new world of taxing jurisdiction commenced.

What *Wayfair* means in the context of this essay is that many businesses that transfer copyrighted works may be newly required to collect sales taxes in jurisdictions across the country. I say "may be" required because the Court did not replace the physical-presence rule with any new bright-line nexus test nor did it give states free reign. Instead, the Court retained the "substantial nexus" requirement of its prior law and stated the requirement was met "when a taxpayer [or collector] 'avails itself of the substantial privilege of carrying on business' in that jurisdiction."[87] That is far less clear of a standard than a physical-presence rule, and the Court did not provide further guidance on that standard in its opinion in *Wayfair*. We all have to dig a bit further for guidance.

The origin of the Court's new nexus language goes back at least to 1940 and the Court's opinion in *Wisconsin v. J.C. Penney Co.*[88] Quite importantly, that case involved the question of nexus under the Due Process Clause, not under the dormant Commerce Clause.[89] The Court also applied the same exact language in *Mobil Oil Corp. v. Vermont*.[90] Again, however, the Court was discussing the Due Process minimum contacts standard in that discussion.[91] Based on this origin, and the use of that standard in *Wayfair*, it seems as though there is significant merit in construing the substantial-nexus requirement as very close to, if not the same as, the Due Process standard.

Due Process requires that a person have "minimum contacts" with a state such that the exercise of jurisdiction over that person would not "offend traditional notions of fair play and substantial justice."[92] That standard generally does not require much and is met when a person "purposefully avails" itself of the benefits of a forum.[93] A vendor who repeatedly ships products into a state will run into trouble. A vendor

[86] 138 S.Ct. at 2094. *Wayfair* involved a statute enacted by the State of South Dakota that imposes a sales-tax collection obligation on vendors who deliver over $100,000 of goods or services into the state, or who engage in 200 or more transactions with South Dakota customers, during a year. *Id.* at 2089.

[87] *Id.* at 2099.

[88] 311 U.S. 435, 444–45 (1940).

[89] *Id.* at 444.

[90] 445 U.S. 425, 442 (1980).

[91] *Id.* at 436–37.

[92] Int'l Shoe Co. v. Washington, 326 U.S. 310, 316 (1945); *see also* M. Elaine Buccieri, *General Requirements of Minimum Contacts with Forum for Due Process and Personal Jurisdiction*, 21 C.J.S. Courts § 46 (2018). Given the Court's historic protection of taxpayers under the dormant Commerce Clause, the precise contours of the Due Process Clause as applied to the impositions of tax have not been fully explored. Scholars have started to pay more attention to this issue. *See, e.g.*, Michael T. Fatale, *The Evolution of Due Process and State Tax Jurisdiction*, 55 SANTA CLARA L. REV. 565 (2015); Hayes R. Holderness, *Taking Tax Due Process Seriously: The Give and Take of State Taxation*, 20 FLA. TAX REV. 371 (2017).

[93] J. McIntyre Mach., Ltd. v. Nicastro, 564 U.S. 873, 877 (2011) (quoting Hanson v. Denckla, 357 U.S. 235, 253 (1958)).

who merely allows a customer in a state to download a single photo may be better off. The boundaries are not clear under current law, but the Court has found minimum contacts to be met because of a single contractual relationship within a state.[94]

The *Wayfair* Court also added another wrinkle to the analysis by suggesting that state tax-collection obligations would also be subject to balancing under the Supreme Court's 1970 decision in *Pike v. Bruce Church*.[95] That case involved a challenge to a non-tax state regulation and solidified the Court's approach to dormant Commerce Clause challenges of that type.[96] In *Pike*, the Court affirmed that state regulations that discriminate against interstate commerce are virtually *per se* unconstitutional.[97] It also stated that nondiscriminatory state regulations "will be upheld unless the burden imposed on [interstate] commerce is clearly excessive in relation to the putative local benefits."[98] That "balancing test" has applied to non-tax state regulations since the 1970s.[99]

It is not quite clear how the Court would apply *Pike* balancing to a state sales tax collection obligation.[100] The Court has largely shied away from engaging in balancing since *Pike*.[101] The *Wayfair* Court did, however, list certain features of South Dakota's law that, if duplicated by other states, would make state requirements likely to be upheld.[102] First, South Dakota's law contains a small-seller exception. It does not require sellers to collect the state's tax unless they make 200 or more sales into the state or make more than $100,000 of sales into the state.[103] Second, South Dakota's law applied only prospectively.[104] Finally, South Dakota is a member of

[94] *See* McGee v Int'l Life Ins. Co., 355 US 220, 233 (1957); *see also* Richard E. Kaye, *Internet Web Activities of Nonresident Person or Corporation as Conferring Personal Jurisdiction Under Long-Arm Statutes and Due Process Clause*, 81 A.L.R. 5th 41 (2000); Jack K. Levin, *Personal Jurisdiction over Nonresidents*, 15B AM. JUR. 2D COMPUTERS AND THE INTERNET §§ 172–176 (2018).

[95] South Dakota v. Wayfair Inc. 138 S.Ct. 2080, 2091, 2099 (2018).

[96] Pike v. Bruce Church, Inc., 397 U.S. 137, 138–41; *see also* DENNING, *supra* note 6, at § 6.02–05 (discussing the Court's vacillating approach to the dormant Commerce Clause prior to its current balancing era).

[97] *Pike*, 397 U.S. at 142.

[98] *Id.*

[99] There is a legitimate debate about whether the Court actually applies this balancing test. *See* Dan T. Coenen, *Where* United Haulers *Might Take Us: The Future of the State Self-Promotion Exception to the Dormant Commerce Clause Rule*, 95 IOWA L. REV. 541, 568–69, 624–27 (2010) (questioning the ongoing validity of *Pike*'s balancing test); Brannon P. Denning, *Reconstructing the Dormant Commerce Clause Doctrine*, 50 WM. & MARY L. REV. 417, 453–59 (2008) (noting common critiques of *Pike*'s balancing test); Donald H. Regan, *The Supreme Court and State Protectionism: Making Sense of the Dormant Commerce Clause*, 84 MICH. L. REV. 1091, 1092 (1986) ("Despite what the Court has said, it has not been balancing.").

[100] Adam B. Thimmesch, *A Unifying Approach to Nexus Under the Dormant Commerce Clause*, 116 MICH. L. REV. ONLINE 101, 108–12 (2018).

[101] *See* DENNING, *supra* note 6, at § 6.05 (describing the evolution of the balancing test post-*Pike*).

[102] South Dakota v. Wayfair, Inc., 138 S.Ct. 2080, 2099 (2018) (stating that "South Dakota's tax system includes several features that appear designed to prevent discrimination against or undue burdens upon interstate commerce").

[103] *Id.* at 2089, 2098–99.

[104] *Id.*

the Streamlined Sales and Use Tax Agreement, which means that it has adopted provisions that reduce compliance costs for vendors.[105]

In the wake of *Wayfair*, many states have enacted similar economic-nexus statutes, so those transferring copyrighted works should be aware that they may have additional tax-collection responsibilities than under the law in prior years.[106] After *Wayfair*, an artist who sells images or music through a website could conceivably be required to collect tax in remote states post-*Wayfair* even if it does no other business there. Artists who have not been collecting state sales tax in "remote" states will need to monitor this closely and evaluate whether they have exposure under states' new laws. Collecting state sales tax has been made simpler by technology, but transfers involving copyrighted works raise many significant questions under states' laws.[107] Collecting tax is not as simple as pushing a button, and it can be costly.

III. BETTER CONSUMING THE BENEFITS OF COPYRIGHT

The materials above discuss several of the sources of complexity and disparity in states' consumption taxes. Those issues are certainly not unique to transactions involving copyrighted works, but they manifest themselves very acutely in that realm. This section addresses whether and how those costs can be minimized or eliminated, either through legal changes or changes to how one does business.

Any discussion of this nature must start by recognizing that pursuing good tax policy often conflicts with other worthwhile policy interests. That is to say that efforts to conform states' tax laws to the normative ideal might undermine federal copyright policy or that efforts to promote the policy interests underlying federal copyright law might cause further deviations of states' tax laws from economists' ideals. It may be, for example, that the best *copyright* answer to the issues addressed in this essay would be for Congress to completely preempt states' abilities to tax copyrighted works. But that would certainly not represent good *tax* policy. That preemption would narrow the tax base, would cause economic distortions, and would undermine states' financial stability. It would also represent a remarkable usurpation of states' retained power within our constitutional structure. The question, then, is whether and how states and Congress can balance the policy interests at stake in this area.

The following sections address three different areas where states, Congress, and businesses could seek to improve the status quo and to better align the tax laws with the interests of those in the copyright realm. Those areas include improving the tax

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[105] *Id.* at 2098–100. The Streamlined Sales and Use Tax Agreement, the SSUTA, is a multi-jurisdictional agreement intended to simply state sales-tax systems by providing uniform definitions and administrative provisions. HELLERSTEIN, *supra* note 11, at 19A.03 (discussing the SSUTA in detail). More information on the SSUTA, and a list of member states can be found at, STREAMLINEDSALESTAX.ORG, https://www.streamlinedsalestax.org/home [https://perma.cc/5X34-4AAA].

[106] *Remote Sellers Nexus Chart*, STREAMLINEDSALESTAX.ORG, https://www.salestaxinstitute.com/resources/remote-seller-nexus-chart [https://perma.cc/W56K-KY8C].

[107] *See* discussion *supra* Part I.

base, improving states' exemptions, and addressing tax-collection obligations post-*Wayfair*.

A. Recalibrating State Consumption Taxes

The state consumption-tax base is disjointed and irrational. Transfers of physical products are almost certainly taxable, but it is hard to offer many generalizations after that. Transactions involving digital versions of tangible products are likely to be taxable, but state practices vary widely.[108] Transactions involving services require a close look at state statutes, and transactions involving some mixture of tangible goods, services, and intangible rights may require an even deeper dive into state guidance and case law. The wide variety of state approaches to their consumption-tax bases means that copyright holders must carefully assess state law and administrative guidance regarding the taxability of their transactions in every state in which they make sales.

If one were to reform state tax systems to be simpler for those engaged in transfers of copyrighted works, the first step would be to remove the artificial distinctions that exist between transfers involving tangible personal property, those involving services, and those involved intangible rights. For example, Iowa recently expanded its sales tax on photographers to apply to sitting fees regardless of whether there is a transfer of a photograph as well and regardless of whether a physical or electronic copy of a photograph is transferred.[109] That expansion certainly increased the transactions that are subject to Iowa's tax, and those engaged in that business could complain about that added cost. That reform, however, also simplified the tax system for those involved in that line of business. That has commercial benefits in addition to just being good tax policy. Again, retail consumption is retail consumption whether the item purchased is a service, a tangible good, or an intangible.[110] Legal reforms that expand states' tax bases to include more retail consumption would thus represent good tax policy and would help to simplify compliance for those engaged in multi-state business.[111]

Of course, there may be certain areas where state reforms do not show appreciable momentum or where states are unreasonably fractured in approach. Similarly, there may be situations where even uniform taxation would be too burdensome. In those cases, it is worth looking to Congress for assistance on a more targeted basis. Consider for example, the Digital Goods and Services Tax Simplification Act, which was first introduced in 2015 and reintroduced in October of 2018.[112] That bill would prevent multiple and discriminatory taxes on digital

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[108] *See supra* note 25 and accompanying text.

[109] *See supra* note 30 and accompanying text.

[110] HELLERSTEIN, *supra* note 11, at ¶12.05[1] ("As a matter of economic theory, there is no distinction between goods, on the one hand, and services and intangibles, on the other hand, that justifies a tax on the former but not on the latter under a retail sales tax.").

[111] This is not to say that expanding the tax base in that way would be the *best* copyright policy. Again, completely exempting these transactions from tax would presumably best promote the creation and distribution of copyrighted works. But that is likely too much to ask of states or of Congress, and it likely promotes copyright too much.

[112] S. 3581, 115th Cong. (2018); S. 851, 114th Cong. (2015).

goods and services and would provide some uniform rules for states to follow it they are going to tax those items.[113] That is an example of a more targeted approach that might help those in the copyright realm, especially post-*Wayfair*.

Whether by state action or by Congressional preemption, those interested in simplifying sales-tax compliance should work to harmonize state tax bases and to eliminate the artificial distinctions that exist in state law between different types of consumption. That simplification would help businesses to focus more on their operations and less on tax. That would be good for everyone.

B. Rationalize Tax Exemptions

Reform would also be useful in the context of state exemptions for business inputs. Purchases of business inputs should generally be exempt from tax to avoid tax pyramiding.[114] Taxing those transactions also necessarily impedes transfers involving those works. This is another area, then, where *tax* interests and *copyright* interest should converge. States should expand their tax exemptions to cover all business consumption involving copyrights.

The difficulty of this type of reform suggestion is not conceptual, it is economic and political. Expanding tax exemptions results in lost tax revenue, which is something that states may not be able to consider. That economic challenge could be further exacerbated by the political challenge of selectively expanding tax exemptions for businesses. Fortunately, there are a few ways that those costs might be offset and that political challenge overcome.

First, the revenue losses that would result from expanding state tax exemptions could be offset, at least partially, by the revenue gains that would accrue to states if they expanded the tax base as proposed above. Additionally, this might be a relatively good time to expand exemptions, given the Supreme Court's recent ruling in *Wayfair*. That decision should result in states getting increased tax collections in the near term, so to the extent that those funds have not already been spent by states, the funds could be used to offset the revenue cost of expanded deductions. None of this is to say that expanding tax exemptions will not result in a net loss in tax revenue, but the situation is not as striking as it would be if those expansions occurred in isolation from other changes.

Finally, as to the politics, efforts to reform a state's tax base and tax exemptions could legitimately be undertaken as modernization efforts. States have great incentives to update their tax systems to reflect how business is done in a modern economy, and expanded tax exemptions for businesses may be a part of that. This is not a situation where a state would be attempting to just give tax breaks to businesses for economic or political reasons. Rather, expanding tax exemptions in this realm would help states to impose more efficient, theoretically sound consumption taxes.

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[113] *See* S. 3581; Paul Jones, *NCSL Task Force Backs Federal Digital Goods Tax Legislation*, 89 ST. TAX NOTES 605, 605 (2018).

[114] Within a flawed sales tax, there may be a case for the taxation of business inputs. *See supra* note 59 and accompanying text.

Tax reform is not easy, but tax reform motivated by a strong state interest in a modern, more fundamentally sound tax base is a different task than one motivated by a singular interest in reducing tax burdens for a select group. Or so one would hope.

C. Manage Tax-Collection Obligations

Whether or not the reform suggestions above are adopted, those engaged in the creation and distribution of copyrighted works will need to grapple with the potential expansion of their sales-tax obligations post-*Wayfair*. Assessing whether and how one will deal with that development should involve one or more of the following: (1) determining whether state laws will absolutely require them to collect tax or whether a small-seller exception might apply; (2) determining whether there are more cost-effective ways to comply with state laws than handling tax collection on their own; and (3) being involved in state and federal discussions regarding these matters.

The first part of this analysis is to consider what level of sales one makes across the country. Most states seem to be adopting small-seller thresholds like South Dakota, so sellers that derive fewer than 200 sales and $100,000 of receipts from a state will largely be protected.[115] It will get trickier if a vendor anticipates making sales that hover around those amounts. It is not clear how states will handle situations where a seller makes that 200th sale in late December. Will they owe tax on all of their sales? Will they have to collect for the next year as well? Those selling works should be very aware of these thresholds and monitor their actions carefully.

If a seller does not want to worry about these things, one option would be to distribute their works though marketplace platforms—think Amazon, GooglePlay, and Etsy. Some of those platforms already collect tax for their sellers, and others may be required to do so by states post-*Wayfair*.[116] There are, of course, online marketplaces specifically for art, music, and software, and those marketplaces may be able to more efficiently implement tax-collection processes than artists, musicians, and coders themselves. It will thus behoove those artists to determine whether distribution through those platforms is preferred. They may prove to be the lowest cost way to distribute work in a post-*Wayfair* world.

With that said, using a platform may not be advisable for everyone. Many sellers might find that their sales are low enough to avoid tax-collection responsibilities. If they use a platform, however, a state may require the platform to collect the tax on their sales. The vendor may thus be paying for a service it does not require. Tax-collection costs should be carefully considered by those deciding how to best distribute their works.

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[115] Paul Jones, Wayfair *Settlement is a Missed Opportunity*, 90 ST. TAX NOTES 745, 745 (2018) (noting that "most states have copied or exceeded South Dakota's threshold"); *see also supra* note 105 and accompanying text.

[116] Lauren Loricchio, *States Want Marketplace Facilitators to Collect for Small Sellers*, 90 STATE TAX NOTES 749, 749 (2018); Michael J. Bologna, *State of Wayfair: More States Asking Amazon, EBay to Collect Tax*, BLOOMBERG BNA (Aug. 1, 2018), https://www.bna.com/state-wayfair-states-n73014481323/ [https://perma.cc/WM8W-6E5V].

Finally, those in the copyright space should monitor and engage in potential state and Congressional action in this area. States are working on their own approaches to tax-collection post-*Wayfair* and they should be cognizant of any special issues presented by copyright. Congress has also long considered bills that would set the boundaries of states' taxing authority, and a number of approaches have been discussed post-*Wayfair*. Some bills have already been introduced.[117] Those in the copyright community should consider whether to engage directly in those efforts. Participation would be particularly useful to get insights that might be unique to the industry.

From a tax perspective, *Wayfair* was a great decision. It removed an arbitrary legal limit on state power and it removed an economic distortion from the market. From a business perspective, however, it introduced more uncertainty. Balancing the state interest in tax collections and the business interests in minimizing compliance costs will be difficult, but that is precisely the role that state legislatures and Congress are to serve. Those in the copyright sphere should bring their thoughts and experiences to bear in the upcoming debates.

CONCLUSION

State consumption-tax issues can seem novel or goofy in their application. Their impact on multijurisdictional actors, however, can be meaningful and unpleasant. Unfortunately, the issues that generally plague the state consumption tax apply very clearly in many cases involving copyrighted works. Attention to these issues is thus warranted, especially after the Supreme Court's recent decision in *South Dakota v. Wayfair*. The distribution of works through modern means allows for easier access to national and global markets, but that expanded access can also result in additional compliance costs that can take time and money from those engaged in business. To the extent that those costs undermine our national interest in promoting the creation and distribution of copyrighted works, it is worth evaluating how simplification efforts could reduce that burden.

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117 Jad Chamseddine, *Groups Push for Remote Seller, Mobile Workforce Bills in Lame-Duck Session*, 90 ST. TAX NOTES 986, 986 (2018); Paige Jones, *Lawmaker Proposes Bill to Resist Wayfair*, 90 ST. TAX NOTES 991, 991 (2018).