CONGRESSIONAL BUDGET OFFICE
COST ESTIMATE

September 14, 2012

H.R. 1860
Digital Goods and Service Tax Fairness Act of 2012

As ordered reported by the House Committee on the Judiciary on June 28, 2012

SUMMARY

H.R. 1860 would prohibit state and local governments from imposing taxes on certain sales of digital goods and services that are taxable under current law.

CBO estimates that implementing H.R. 1860 would have no impact on the federal budget. Enacting H.R. 1860 would not affect direct spending or revenues; therefore, pay-as-you-go procedures do not apply.

The bill would impose an intergovernmental mandate as defined in the Unfunded Mandates Reform Act (UMRA). CBO estimates that the cost of complying with that mandate would exceed the threshold established in UMRA for intergovernmental mandates ($74 million in 2013, adjusted annually for inflation). The bill contains no new private-sector mandates as defined in UMRA.

ESTIMATED COST TO THE FEDERAL GOVERNMENT: None.

ESTIMATED IMPACT ON STATE, LOCAL, AND TRIBAL GOVERNMENTS

H.R. 1860 would impose an intergovernmental mandate as defined in UMRA by prohibiting state and local governments from taxing certain sales of digital goods and services. CBO estimates that the cost—in the form of forgone revenues—to state and local governments would total more than $3 billion in the first full year after enactment (2013) and at least that amount in each subsequent year. The costs would far exceed the threshold established in UMRA for intergovernmental mandates ($74 million in 2013, adjusted annually for inflation).

Specifically, the bill would prohibit state and local governments from imposing taxes on the sales of digital goods and services under any one of the following conditions:

- The purchaser intends to resell the good or service;
- The tax is applied through regulation, administrative ruling, or law that has not been determined by a court to be valid;
- The customer's tax address is not within the state or locality;
- The taxing jurisdiction does not reduce the tax owed by the amount of taxes paid to other jurisdictions; or
- The tax rate applied to the digital good or service is higher than the rate that would apply to a similar good or service that is not delivered electronically.

The bill also would prevent state and local governments from imposing taxes on revenues generated by businesses that take and fulfill orders for, provide billing services for, or deliver digital goods and services on behalf of sellers of digital products or services.

BASIS OF ESTIMATE FOR THE INTERGOVERNMENTAL MANDATE

UMRA includes in its definition of mandate costs any amounts that state and local governments would be prohibited from raising in revenues as a result of complying with the mandate. The mandate costs of H.R. 1860 would include any taxes that state and local governments would be precluded from collecting under the bill. (UMRA's definition of mandate costs excludes increases in revenues that state and local governments might collect in reaction to enactment of a mandate.)

CBO estimates that most states and some local governments would see an immediate revenue loss upon enactment of H.R. 1860 because they are currently collecting taxes on sales that, under the bill, would be exempt from taxation. Subsequently, businesses likely would rearrange their activities to take advantage of beneficial tax treatments that would result from the interaction of the new federal law and certain state taxing regimes. Those changes in business activities would probably result in additional revenue losses to the states. However, CBO has no basis for estimating the extent to which such reorganizations would occur and has not included an estimate of such losses in the mandate costs noted above.

CBO used information from a variety of sources to estimate the state and local revenue losses that would result from enacting this legislation. Using data from the states, industry, academia, and the U.S. Bureau of the Census, CBO estimated potential losses based on current tax collections, the structure of state and local taxing systems, and national sales of digital goods and services.

In the absence of clear definitions, CBO made several assumptions about the meaning of key terms in the bill. Those assumptions include the following:

- Services that are provided to the consumer electronically, such as data processing and storage, database, online marketplace, and Web site services, are *digital services*;

- Items that are downloaded by consumers, such as software and software updates, books, games, apps, and pay-per-view movies, are *digital goods*;

- Items that are purchased over the Internet and mailed to the consumer are not *digital goods*; and,

- Items that are purchased over the Internet and received in person, such as tickets to a concert or movie, are not *digital goods*.

Those and other assumptions were necessary to identify the scope of goods and services that would be affected by the bill's limits on taxation.

States use a variety of rules to determine whether sales and revenues are taxable under current law. Differences in the taxing systems of individual states affect how much revenue each state or local government would be likely to forgo under the provisions of the bill. CBO examined both the characteristics of the sales tax structure of each state and data about sales in each state to estimate potential revenue losses.

To estimate the costs of enacting H.R. 1860 to state and local governments, CBO first used census data and market studies to estimate the total sales of digital goods and services to customers in each state. Since many states exempt purchases by entities such as governments, nonprofits, educational institutions, and religious organizations from sales taxes, CBO used additional information from the states and academic studies to calculate the portion of sales taxes that could be at risk if H.R. 1860 were enacted. Such taxes totaled about $6 billion in 2012. In general, CBO expects that states would lose about 40 percent of sales taxes on digital goods and services—or nearly $3 billion—in the first year after enactment (2013), nationwide. About a third of that loss would result from the bill's preemption of laws, regulations, or administrative rulings that apply taxes on tangible personal property to digital goods or services, unless a court has determined that application to be valid. In particular, state and local governments that tax downloaded software and data processing services would incur substantial losses. To calculate losses for that year, CBO estimated the likely percentage each state would lose based on its current tax system and applied that percentage to the sales taxes potentially at risk.

In addition to lost revenues from sales taxes on digital goods and services, state and local governments would forgo about $100 million annually as a result of the bill's prohibition on collecting occupancy and sales taxes on the difference between the amount that hotels collect and the amounts that hotel occupants pay for hotel rooms when the occupants book rooms online.

In total, lost revenues from enactment of H.R. 1860 would total between 1 percent and 2 percent of state and local sales taxes on all goods and services due in 2013, CBO estimates.

The percent of revenues lost by each state would vary significantly and depend on the characteristics of each state's tax system. A state that imposes taxes on sales of digital goods and services by an administrative ruling or regulation that has not been approved by a court would lose a higher percentage of their sales tax revenues than a state that imposes such taxes by law. Similarly, a state that imposes taxes on the sale of digital goods and services to buyers that intend to integrate the item into a digital good or service that they resell would also lose a higher percentage of their sales taxes than a state that exempts such sales from taxation.

In the absence of this legislation, it is possible that some state and local governments would enact new taxes or change the way they tax sales of digital goods and services. Since such changes are difficult to predict, for the purposes of estimating the direct costs of the mandate, CBO considered only the revenues from taxes that are currently in place and actually being collected, or estimates for changes that are already in statute and that will be implemented over the next five years.

ESTIMATED IMPACT ON THE PRIVATE SECTOR

This bill contains no new private-sector mandates as defined in UMRA.

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