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Maryland’s Digital Goods Tax Requires Planning and Coordination

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Collaboration is essential among tax departments, IT, marketing, and product teams to comply with new digital products rules such as those in Maryland. This is a potentially monumental task when evolving rules and definitions vary among states and continue to change, says KPMG’s Joni Johnson-Powe.

The US indirect tax landscape is evolving to keep up with new technologies and the expansion of the digital economy. Complex indirect tax rules require complex planning by companies not only to collect and remit taxes but also to assess them accurately. It’s crucial to develop upstream processes such as gathering customer information and ensuring granularity of product attributes to determine taxability in systems and software setups.

Over the last few years, the Maryland Office of the Comptroller has been at the forefront of the digital tax movement, adding a gross receipts tax on digital advertising and expanding its sales tax base to include digital products. While the Maryland digital advertising tax has garnered significant attention, there’s been far less focus on the broadened sales and use tax on digital goods, which took effect last year. Furthermore, Maryland recently passed supplemental legislation that further defined digital products and updated its Business Tax Tip #29 Sales of Digital Products and Digital Codes in July to reflect the new law.

Although many of Maryland’s provisions related to sales and use tax of digital products mirror those of other states, there are some unique distinctions, such as including software as a service as a digital good.

Maryland’s rules impose a sales and use tax on the sale or use of a digital code or digital product obtained or delivered electronically by an end user—this includes subscriptions, access, receipt, and streaming of a digital code or digital product. The sales and use tax applies regardless of whether the buyer has the rights of permanent use, rights of less-than-permanent use, or rights of use conditioned on continued payment by the subscriber or buyer.

The definitions of a digital product present some interesting nuances for a seller attempting to ensure it accurately charges the sales to tax its customers. Under Maryland law, a digital product is obtained electronically or delivered through electrical, digital, magnetic, wireless, optical, or electromagnetic technology and includes:

- Sound transferred electronically: Prerecorded or live music, readings of books, and speeches;
- Audio greeting cards sent by email;
- A digitized sound file such as a ring tone;
- Motion pictures, musical videos, news and entertainment programs, live events, video greeting cards sent by e-mail, and video or electronic games transferred electronically;
- E-books that are transferred electronically; and
- A newspaper, magazine, periodical, chat room discussion, weblog, or any other similar product that is transferred electronically.

Maryland's statute doesn't specifically address software in the definition of a digital product. But Business Tax Tip #29 confirms that software delivered electronically including software as a service is subject to Maryland sales tax unless it constitutes customized software, defined as that which doesn't operate out of the box as the user intended.

The supplemental legislation enacted in April excludes cloud enterprise computer systems—purchased solely for commercial purposes that the purchaser houses or maintains on a cloud server—from the definition of a digital product. Although an enterprise computer system isn't defined by statute, Business Tax Tip #29 states that it includes a purchase or license of software for simultaneous use on multiple computers that is housed on an enterprise server, cloud server, or end users' computers.

From an operational and technology perspective, setting up billing and tax systems can be challenging for taxpayers selling software in Maryland. By creating exclusions from the definition of digital products, sellers must distinguish in their systems:

- The types of purchasers, such as businesses, sole proprietors, and individuals;
- Anticipated uses of the software such as single use, multiple users, commercial, and personal; and
- Deployment methods such as cloud, on-prem, custom or off the shelf.

Even with an integrated tax software solution, the precision of the tax calculation depends on the accuracy and granularity of the information received from the billing platform, e-commerce system, or enterprise resource planning.

Similar considerations affect images, video and art transactions, and training services delivered electronically. Maryland's new digital products definitions exclude purchases of images, videos, music, or art with a copyright, or intellectual property interest when used solely for commercial purposes such as advertising or marketing activities. Logos or other marketing material that don't have a copyright or trademark will need to be designated separately from those with inherent property rights when sold by advertising agencies.

Electronically delivered trainings also have a few relevant exclusions to consider. For electronically delivered classes, seminars, and conferences that aren't excluded from Maryland's definition of a digital product, taxpayers invoicing customers will need to account not only for the mode of delivery but also for the type of purchaser and the nature of seminar, such as professionals seeking continuing education.

Maryland is not unique; many states have expanded their sales and use tax bases as the digital economy has changed the way products and services are delivered and consumed. However, Maryland's regulations shift the burden of determining taxes on digital goods to the seller from the purchaser. The complexity of Maryland's taxable base definitions reallocates the burden from the purchaser to the seller. Rather than requiring proof of exemption from purchasers, sellers must account for product and services tax exclusions through upstream multi-level definitions and configurations of identifying who is purchasing an item and how it will be used.

To comply with new digital products rules like those in Maryland, collaboration is essential among tax departments, IT, marketing, and product teams to optimize customer onboarding processes and set up product and service definition granularity in host systems. This is a potentially monumental task when evolving rules and definitions vary widely among states and continue to change.

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