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U.S.

States Eye Taxes on Streaming Video and Cloud Computing

Decline in DVD and CD sales has taken a bite out of revenue in recent years

Shoppers look through a bin of $1.99 DVD movies at a Best Buy Co. store in Peoria, Ill., ahead of Black Friday in November 2013. Dollar sales of DVDs have been sagging for years. *PHOTO: DANIEL ACKER/BLOOMBERG NEWS*

By **MARK PETERS** And **GREG BENSINGER**
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State tax officials are trying to catch up with fans of "Orange Is the New Black" and One Direction.

With sales of DVDs, video games and traditional packaged software slumping for years, more state and local governments are eyeing technologies such as streaming video subscriptions and cloud computing to help make up for hundreds of millions of dollars or more in lost revenue.

Applying age-old sales taxes to the era of new media hasn't been simple. States have long taxed tangible goods, but the broad array of new digital products often don't fit the category. Some states are trying to use existing laws, while others are taking on the politically thorny task of rewriting tax rules.

The result is a patchwork of tax policies—and some new laws—for fast-growing slices of consumer and business sales. While taxes on digital entertainment and software represent only a sliver of the $271 billion that states collected in sales taxes last year, the issue highlights the challenge states and localities face as technologies rapidly shift.

"What's so hard about digital goods is they move so fast there's not the time for states to grasp them and figure out what to do," said Diane Yetter, president of

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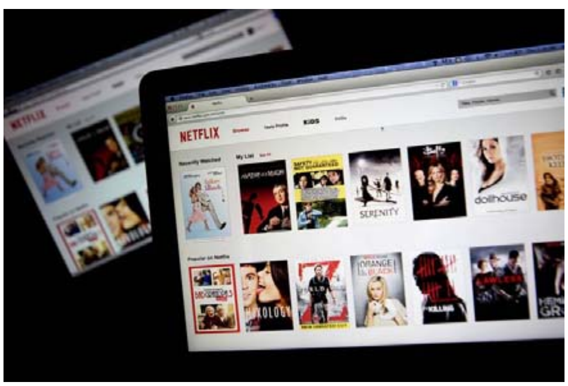
Yetter, a Chicago-based sales-tax consultancy.

Last month, Tennessee extended its 7% sales tax to software and digital games that are accessed remotely. Meanwhile, Chicago is one of the first cities to wade into taxing digital goods, requiring in the coming months local taxes on cloud computing and streaming entertainment.

But Alabama lawmakers recently shelved its own " Netflix tax" after months of study, and Vermont ended an effort to levy taxes on cloud computing after finding the technology was more akin to a service than a tangible good.



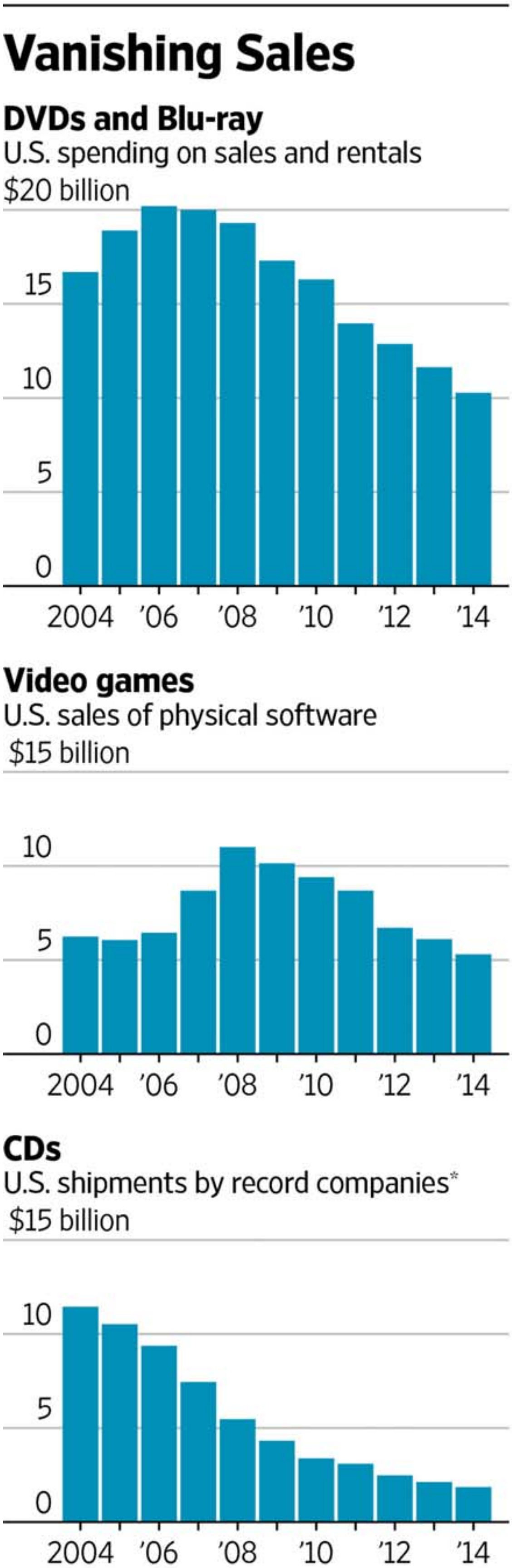
The Netflix Inc. website is displayed on laptop computers in this arranged photograph in Washington, D.C., last year. *PHOTO: ANDREW HARRER/BLOOMBERG NEWS*

States and cities have struggled for decades with shrinking tax bases, often driven by the decades-long decline of manufacturing, but also the more recent rise in e-commerce, which is hard to police when individuals buy goods from out-of-state companies. Nationally, the average, inflation-adjusted growth rate for state sales-tax revenue was 1.5% between 2004 and 2014, down from 3.1% a decade earlier, according to Nelson A. Rockefeller Institute of Government at the State University of New York.

"There's a concern when you have something that the state as a policy matter has clearly chosen to tax, but it starts not being taxed because of changes in technology," said David Gerregano, deputy revenue commissioner of Tennessee, which expects to collect $11.3 million in the first year following its tax changes, providing some additional revenue for the state's multibillion-dollar budget.

States still don't have a handle on how much revenue they have lost from the decline of physical media, because they typically don't track tax collections for specific items.

Annual U.S. spending on sales and rentals of DVD and Blu-ray discs have fallen to just over $10 billion from a peak of $20.2 billion less than a decade ago, according



*Net returned merchandise
Sources: Digital Entertainment Group (DVDs); NPD Group (video games); Recording Industry Association of America (CDs)

to data from Digital Entertainment Group, a trade association. Sales of CDs have seen an even sharper decline, with data from the Recording Industry Association of America showing record-company shipments fell to $1.9 billion last year from $13.2 billion in 2000. Sales of video games also have fallen steeply in recent years.

States have likely lost hundreds of millions of dollars a year in tax revenue from those three items, perhaps more than $1 billion. Not all states assess sales tax, and in the 45 states that do, rates range from less than 3% to more than 7%, when local taxes aren't included.

As CD and DVD sales have fallen, first downloads and then streaming subscriptions have notched rapid growth. Netflix Inc., for instance, drew in $2.01 billion in sales in this year's first half from its U.S. streaming video business. The company says its offerings are currently taxable in roughly half of U.S. states and certain municipalities.

Another fast-growing area that could bolster state coffers is cloud computing, an amorphous term that includes renting online computing storage and using remote Internet-connected servers for number crunching. Gartner Inc. projects the cloud-computing market in the U.S. will reach $115 billion next year, which includes business processing, infrastructure and security.

Idaho has moved cautiously on taxing cloud computing and streaming video. Two years ago, the state decided to exempt most cloud-based software from sales taxes, viewing it as a service. The following year, it exempted downloadable software, while taxing digital music, video, books and games, according to the state tax commission.

Netflix, which determined it had to collect sales taxes on subscriptions under the Idaho law, fought the law at the capitol in Boise. “Netflix unquestionably provides a service, not the sale or rental of digital products,” the company said in comments to the Idaho State Tax Commission.

Earlier this year, Idaho legislators passed a new law specifying that unless the consumer got a permanent right to the content, it wasn’t taxable, which exempts streaming services from the sales tax.

Meanwhile, Chicago is facing pushback from businesses for its effort to drum up about $12 million a year in taxes from various digital offerings. For now, the city has extended the period for businesses to come into compliance on cloud computing to the start of next year, and new exemptions are under discussion.

Asked about Chicago’s move, a Netflix spokeswoman said the company has “no broader policy beyond reviewing situations on a case-by-case basis.”