

## What Digital Divide?

### *Application of “Analog” Municipal Sales Tax Codes to Digital Products*

Colorado Municipal League  
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## The Problem

- Colorado imposes sales tax “[o]n the purchase price paid or charged upon all sales and purchases of tangible personal property at retail,” along with specified services. C.R.C. § 39-26-104. ¶ 16
- The Colorado taxing statute specifically defines “tangible personal property” to mean “corporeal personal property.” C.R.S. § 39-26-102(15)(a)(I). ¶ 18  
*Netflix Inc. v. Colorado DOR*, No. 2021CV30691 (Dist. Ct., City & County of Denver) (Complaint, Feb. 25, 2021).

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## The Problem (Continued)

- Netflix’s Streaming Service is not and has never been the sale or taxable lease of tangible personal property as defined by C.R.S. § 39-26-102(15)(a)(I). ¶ 19
- The Streaming Service never has involved and does not now involve the sale or taxable lease of tangible personal property as defined by § 39-26-102(15)(a)(I). ¶ 20

*Netflix Inc. v. Colorado DOR*, No. 2021CV30691 (Dist. Ct., City & County of Denver) (Complaint, Feb. 25, 2021).

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## Definitions

- “Tangible personal property ... means corporeal personal property.”
- Corporeal means physical, material existence, tangible. *Black’s Law Dictionary*, 172 (10th ed. 2014).
- Tangible personal property: (1) having or possessing physical form; corporeal; (2) capable of being touched or seen; perceptible to the touch; capable of being possessed or realized; (3) capable of being understood by the mind. *Id.* at 606.

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## Extrapolation from Definitions

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- Transactions that transmit only “knowledge” or “information” or “data” remain intangible.
  - Unaided human senses determine tangibility.
  - Human perception aided by machine or device does not count.
  - No matter or mass exchanges during the transaction and, thus, the transaction remains wholly intangible.
  - Streamlined Sales and Use Tax Agreement (“SUSTA”) digital products are a separate class of property beyond the scope of the definition of “tangible personal property.”

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## Intangible rights control?

- License provides legal rights to reproduce and to sell the digital product.
- Contract provides legal rights to distribute the digital product.
- Contract creates a legal right to exhibit and/or to display the product.

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## Basic Science

“As stored on a hard drive, data consists of the arrangement of hundreds of thousands of atoms of cobalt, iron and other magnetic materials in a perceivable and unique pattern. The data consists of small electromagnets in certain alignments.”

*America Online Inc. v. St. Paul Mercury Insurance. Co.*, 347 F.3d 89, 94 (4th Cir. 2003).

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## Why the argument fails:

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- Closed syllogism / Circular argument.
  - Make assumptions to support the desired conclusion.
  - Select facts to support the assumptions.
  - Select authorities to support the facts and assumptions.
  - Reach the predetermined conclusion.

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## Why the argument fails:

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- Hasbro argued software programs are not “perceptible to the senses” because they consist of invisible and inaudible electronic impulses that instruct computers to display stored data in a particular manner.
  - Invisible and inaudible electronic impulses instruct the computer, but the impulses do not simply float in space.
  - Electronic impulses must exist in some physical medium.
  - “[T]he software program ... is no different from other taxable personal property such as films, videotapes, books, cassettes, and records whose value lies in their respective abilities to store and later display or transmit their contents.”

*Hasbro Industries Inc. v. Norberg*, 487 A. 2d 124 (R.I. 1985)

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## Why the argument fails:

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- Master License Agreement between Distributor and Exhibitor requires all “Physical Media” shall remain the exclusive property of Distributor.
  - Exhibitor shall not permit any lien, pledge, mortgage, or other encumbrance to attach to any Physical Media from the Exhibitor given possession of the data file but shall not duplicate Physical Media or any part thereof.
  - “Distributor shall deliver a positive print of the [Motion] Picture in physical condition suitable for exhibition.”

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## Why the argument fails:

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- Master License Agreements describe digital products as “physical media” occupying physical space and subject to taxation as tangible property.
  - MLAs repeatedly include terms reflecting physical “transport” or “transmit” or “distribute” or “deliver” or “ship” of individual copies of digital products.
  - MLAs repeatedly include terms reflecting responsibilities to “receive” or “accept” or “pick up” or “take possession” of individual copies of digital products from distributors.

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## Why the argument fails:

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- Colorado has refused to adopt the Streamlined Sales and Use Tax Agreement (“SUSTA”).
  - CDOR “view[s] digital goods, such as digital music, movies, books, and photographs, as tangible personal property because they are not merely a concept or idea, but, rather, are part of the physical world.”
  - “Intangible personal property is conceptual in nature, such as a contract, stock, and goodwill. ... [D]igital goods ... refer[ ] not to a concept but, rather, to something that exists in the physical world .... Digital documents ... have a physical existence and are no less taxable than had they been delivered in paper or celluloid form.”
  - CDOR “will continue treating the sale of electronically delivered goods, such as music, movies, and books, as taxable sales of tangible personal property.”

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## Why the argument fails:

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- Tangible property or corporeal property includes property that may be seen, weighed, measured, felt, or touched, or perceived by the senses *in any manner*.
- Tangible property includes property perceived with the senses in any manner – especially as the creator designed the products for use.

*Accord Steamboat Springs Rental & Leasing, Inc. v. City & County of Denver*,  
15 P.3d 785, 787 (Colo. App. 2000)

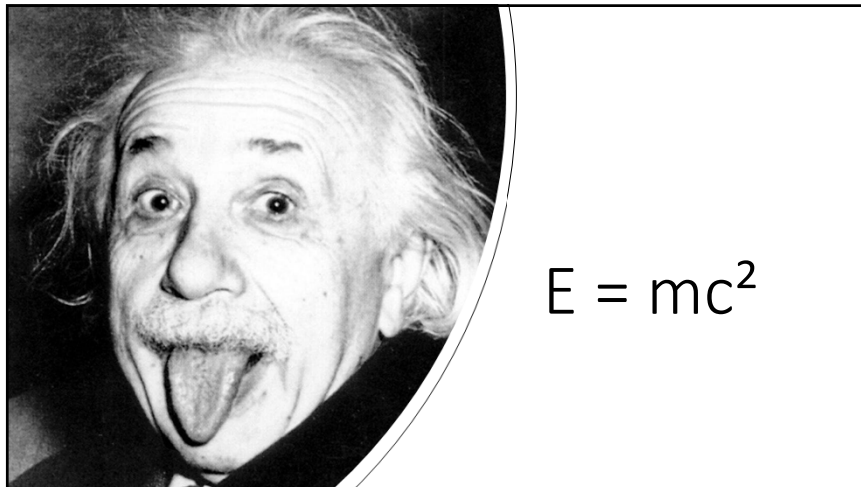
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## Modus tollens (Propositional logic)

- Biconditional Introduction.
- A true statement has a true contrapositive statement. Example, if  $2 + 2 = 4$ , then  $4 = 2 + 2$ .
- Example: If digital products constitute tangible personal property, then digital products can be stored, secured, copied, *et cetera*; If digital products can be stored, secured, copied, *et cetera*, then digital products constitute tangible property.

See [https://en.wikipedia.org/wiki/Biconditional\\_introduction](https://en.wikipedia.org/wiki/Biconditional_introduction);  
see also [https://en.wikipedia.org/wiki/Modus\\_tollens](https://en.wikipedia.org/wiki/Modus_tollens)

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## Definition for Intangible Property

- Intangible property remains impervious to impacts by tangible property.
- You cannot strike constitutional or legal rights with a hammer.

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## Criteria for Tangible Property

- (1) Value in commercial transaction and/or transfer;
- (2) Requirements of physical space and time apply;
- (3) Perception with senses in any manner (especially as intended by its creator);
- (4) Replication or manufacture in identical units;
- (5) Subject to security measures (physical & digital);
- (6) Subject to legal protection (physical & intellectual); and
- (7) Subject to taxation historically.

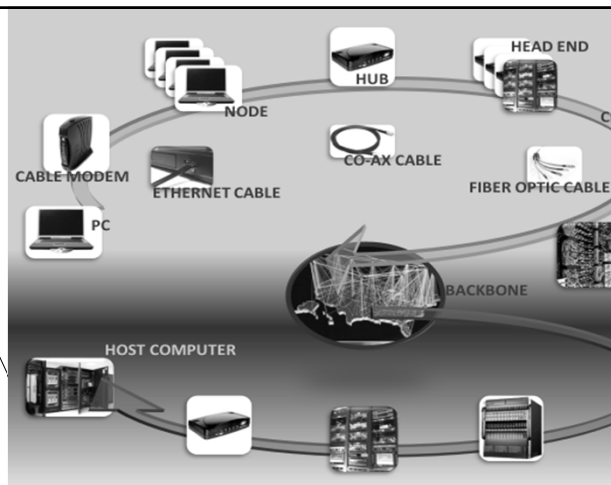
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## Subject to a transaction for value.

- Municipality assesses tax as a percentage of transactions.
- Without transactions for value, nothing exists to tax.
- Without transactions for value, nothing exists to audit.
- Examples: (a) Digital motion pictures, (b) digital music, (c) satellite radio, (d) streaming video, (e) cable television.
- *Non curamus; non necessarium est.*

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## Subject to requirements of space and time.



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## Replication or Manufacture in identical units.

- Motion picture distributors replicate an exact copy of digital motion pictures and deliver copies to theaters.
- Theatres replicate each digital motion picture from the library server to a digital projector and a digital sound system.
- After first run showings, motion picture distributors may replicate for distribution and rent through pay television, Redbox, Netflix, and Amazon Prime.
- Motion picture distributors subsequently replicate copies of digital motion picture for retail sale.

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## Security Measures (physical)

- Authorized signature to receive data files.
- Access limited to approved personnel.
- Server rooms under lock and key.
- Security cameras to prevent unauthorized access.
- Security personnel.
- Consequences for unauthorized access.

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## Security Measures (electronic / digital)

- Password protection for computer access.
- Encryption of data files.
- Preapproved website access.
- Electronic security key.
- Expiration of website access.
- Electronic monitoring of access.
- Hash value verification.

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## Legal Protection (physical & intellectual)

- |  |   |
|--|---|
| <ul style="list-style-type: none"> <li>• Criminal theft</li> <li>• Medical records theft</li> <li>• Civil theft</li> <li>• Conversion</li> <li>• Trespass to chattels</li> <li>• Misappropriation</li> <li>• Personnel policies</li> </ul> | <ul style="list-style-type: none"> <li>• HIPAA</li> <li>• HITECH Act</li> <li>• Trade Secrets</li> <li>• Copyright</li> <li>• Digital Medium Copyright Act</li> <li>• Computer Fraud &amp; Abuse Act</li> <li>• Insurance coverage</li> </ul> |
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## Theft

- If digital data remains subject to theft, then digital data must involve tangible property.
- Forty-seven states and six U.S. territories have statutes related to notification of security breaches of an individual's personal information in digital form.
- Colorado authorizes the Attorney General to bring an action for a data security breach of digital personal information. Colo. Rev. Stat. § 6-1-716(4).
- Colorado defines a "breach of the security of the system" as "the unauthorized acquisition of unencrypted computerized data that compromises the security, confidentiality, or integrity of personal information maintained by an individual or a commercial entity." *Id.* § 6-1-716(1)(a).

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## Conversion

- Digital media remains “capable of being converted” because “digital media is both tangible (*i.e.*, capable of being seen on an electronic device’s screen) and transferable (*i.e.*, subject to an exertion of ownership or dominion).”
- “Because shares of stock can be transferred by mere computer entries, a thief can use a computer to access a person’s financial accounts and transfer the shares to an account controlled by the thief.”
- “Computers and digital information are ubiquitous and pervade all aspects of business, financial and personal communication activities. Indeed, this opinion was drafted in electronic form, stored in a computer’s memory and disseminated ... via e-mail. ... [No] reason [exists] in law or logic why ... virtual creation should be treated any differently from production by pen on paper or quill on parchment. A document stored on a computer hard drive has the same value as a paper document kept in a file cabinet.”

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## Trespass to Chattels

- Trespass to chattels occurs when one party intentionally uses or intermeddles with personal property in rightful possession of another without authorization.
- Computers and computer networks contain tangible personal property and, therefore, an unauthorized and intentional use of the computers and network constituted a trespass to chattels.
- “The transmission of electrical signals through a computer network is sufficiently ‘physical’ contact to constitute a trespass to property.”
- *America Online, Inc. v. LCGM, Inc.*, 46 F. Supp. 2d at 451-52; *CompuServe Inc. v. Cyber Promotions, Inc.*, 962 F. Supp. 1015, 1021 (S.D. Ohio 1997).

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## Copyright Act

- Copyright Act grants owners of “works of authorship” the exclusive rights to “reproduce the copyrighted work in copies” and to “distribute copies ... of the copyrighted work to the public by sale or other transfer of ownership, or by rental, lease, or lending.” 17 U.S.C. § 106.
- Copyright Act explicitly provides protection “in original works of authorship fixed in *any tangible medium of expression, now known or later developed*, from which they can be *perceived*, reproduced, or otherwise communicated, *either directly or with the aid of a machine or device*.” 17 U.S.C. § 102(a) (emphasis added).

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## Taxation Historically

- Change from traditional to digital delivery does not render products untaxable.
- Motion Pictures
- Magazines
- Books
- Newspapers
- Music (singles & albums)
- Photographs
- Computer Software

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## Taxation Hysterically

- No principled reason exists why the retail sale of products that can be delivered electronically due to technology, *i.e.*, photographs, music, movies, books, *etc.*, should be taxed any differently than the sale of the same products delivered by traditional means.
- In all cases, the true object of the transaction is the sale of the products, not the providing of a non-taxable service.
- Digital tangible personal property can be seen, heard, weighed, measured, felt, or touched or that is perceptible to the senses in any other manner.
- Downloaded digital products remain tangible because they cause physical changes to the storage medium that can be measured.

Catherine Chen, *Taxation of Digital Goods and Services*, 70 N.Y.U. Ann. Surv. Am. L. 421 (2015) (taxation of digital goods and services)

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## True object or dominate purpose test

Apply various factors to determine whether the “true object, dominant purpose, or essence” of the transaction involves tangible property or intangible rights.

- (1) comparative value of tangible product vs. intangible right;
- (2) alternative means of transfer for the product;
- (3) similar taxation of functionally equivalent transactions regardless of technologies;
- (4) length of time that the information in the product retains its value;
- (5) constraints on the use the tangible property and intangible property;
- (6) what happens to tangible property after it has yielded the intangible component;
- (7) does the tangible property represented a finished product;
- (8) Any skill or expertise required of the lessee, transferee, or purchaser; and
- (9) other characteristics of the transaction that make it more analogous to a traditional lease, transfer, or sale of goods, or to a traditional lease, transfer, or sale of an intangible right or service.

*City of Boulder v. Leanin’ Tree, Inc.*, 72 P.3d 361, 363 (Colo. 2003)

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## Response to claims of exemption from tax

- *Illigiti non carbrundum.*
- “Don’t let the bastards get you down.”
- Apply factors for tangible property.
- Apply definition of intangible property.

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## Making the Record



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▽  
**Court's  
Concluding  
Statement**

Counsel, I've been a judge here -- a district court judge for eight years. · Most of the first five years was criminal, but the last three years has been civil. · I think I've seen some of the best attorneys practice in my courtroom, criminal and civil. I don't think that I'm telling people who are in the courtroom anything that they haven't already recognized, but these are very professional, extremely courteous, very knowledgeable, and outstanding legal counsel on both sides. · I appreciate that. · It made the case go much, much easier.

- Judge Kurt Horton, Trial Transcript, June 23, 2016

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## Contact Information

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