

Proposed Uniform Definitions for the Tax Base – 20240201 Draft

The following definitions are proposed for inclusion in the MTC's Digital Products Workgroup whitepaper as definitions that could be used by states to modify their sales and use tax bases regarding digital products.

A. Definitions

1. "Generic digital product" - an item, including software and service, that is in a binary format intended to be used by an electronic device, and that has not been customized by the provider for the individual customer. The term does not include a digital code or communication that conveys access or rights to another product. The term does not include an item that is furnished to a commercial enterprise for exclusive use by the commercial enterprise.
2. "Customize" – to make a unique product for a customer, or to modify an existing product to provide a unique benefit that that is unavailable through the "off-the-shelf" product. Customizing a product does not include modifying the product for different customers when the marginal cost to the provider of making the individual modification is nominal. Customizing a product does not include configuring the product, that is, activating, deactivating, arranging, combining, segregating, or otherwise adjusting "off-the-shelf" functionalities to suit the needs of a particular customer.

B. Commentary

1. Electronic devices include computers, cellular telephones, and other devices that can process binary data.
2. Customization is determined by the activity of the provider of the product to modify the product, and not by the activity of the customer to use or adapt the product.
3. If a modification of an existing product for different customers is automated, i.e., performed with minimal human involvement, the marginal cost is presumed to be nominal. These concepts are discussed in the [United Nations Model Double Taxation Convention Between Developed and Developing Countries](#), Box 2.2 (2021), [OECD, "Tax Challenges Arising from Digitalisation – Report on Pillar One Blueprint: Inclusive Framework on BEPS"](#), Commentary on Article 12B ¶¶ 53 & 54 (2020), and [Working Paper No. 919](#) of the Value Added Tax Committee of the Taxation and Customs Union of the European Commission of the European Union (2017).
4. The use of an algorithm to tailor a product to a customer's preferences is likely to be configuration, or a modification in which the marginal cost of the individual modification is nominal.
5. A state could narrow the application of the definition of "generic digital product" by taxing only specific types of generic digital products, or by excluding specific types of generic digital products. And, a state could separately tax customized digital items, or charges for customizing digital items.
6. The definition of "generic digital product" would include digital telephone service but not analog telephone service. A state that has a separate taxing regime for telecommunication service could specifically exclude such service.

7. The definition of “generic digital product” would include Internet access service, and no allowance is made for the federal Internet Tax Freedom Act preemption. A state statute should not lock in a federal statutory preemption, which could change. Furthermore, the preemption does not cover all Internet access service. The federal preemption is better addressed in state regulations.

C. Examples

1. The publication or public performance of a copyrighted work in a digital format for a fee would generally constitute the sale of a generic digital product. Examples include the sale of downloaded digital books or music, the sale of music or video streaming service subscriptions, and the sale of digital recordings on a tangible storage media such as compact discs. However, the sale to a commercial enterprise of publishing or performance rights would not constitute the sale of a generic digital product.
2. The charge for an attorney’s title opinion received by the customer in a binary format, such as Portable Document Format (PDF), would not constitute the sale of a generic digital product because the title opinion is customized for the individual customer.
3. The sale of a subscription to an online computer gaming service would constitute the sale of a generic digital product. The sale of a character enhancement for a computer game would constitute the sale of a generic digital product.
4. The sale of a subscription to a digital legal research engine would constitute the sale of a generic digital product.
5. The sale of a digital code or digital ticket to attend a concert in person would not constitute the sale of a generic digital product, but the sale of a digital code authorizing digital access to a live-streamed concert would constitute the sale of a generic digital product.

D. Discussion

In principle, a retail sales tax should be a broad-based single-stage levy on consumer expenditures with a low tax rate. In practice, in most states, the sale of tangible personal property is generally taxed, while only the sale of specific services is taxed.

Digital products do not fit well with the traditional sales tax distinctions between the sale of taxable tangible personal property and the sale of nontaxable services. Digital products tend to be less “tangible” than nondigital products. As result, many states specifically include computer software in the statutory definition of tangible personal property. And now, the distinction between software and services is becoming blurred, such that the term “software as a service” has come into use.

For these reasons, states with selective tax bases may recognize that digital products deserve a separate classification in the tax base. In some cases, the classification will overlap with existing, traditional tax classifications. In other cases, the classification may expand the tax base, since digital products often have distinct attributes that justify distinct tax treatment.

The proposed definition has four parts with four objectives. The first part describes “an item, including software and service, that is in a binary format intended to be used by

an electronic device.” The objective of this part is to eliminate the arbitrary distinction between software and services.

The second part of the definition excludes a digital item that is “customized” by the provider for the individual customer. The objective is to make the definition more compatible with the selective tax systems of the many states that do not broadly tax professional services. The term “customize” is defined in such a way that the term “generic digital product” will generally include an automated product, and will generally exclude a product that requires significant human effort to complete the product for individual customers.

The third part of the definition excludes a digital code or communication that conveys access or rights to other products. The objective is to base taxability on the underlying product. The Streamlined Sales Tax Agreement provides this result for specified digital products and products transferred electronically.

The fourth part of the definition excludes digital items furnished to a commercial enterprise for use by the commercial enterprise. The objective is to prevent the pyramiding of taxes. The exclusion also eliminates the taxation of transactions traditionally treated as the nontaxable sale of intangible rights, such as the sale of digital publishing or performing rights. Also, the exclusion reduces sourcing difficulties that may result from commercial transactions that involve multiple business users at multiple locations.

The uniform definition does not preclude states from narrowing its application to specific products, or excluding specific products from the definition. Possibly, the work group could articulate specific inclusions or exclusions that states could consider.