

Proposed Uniform Definitions for the Tax Base – 20250116 Draft

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

- A. Definition for the tax base: “Automated digital product” - an item, including software and service, that is provided for noncommercial use in a binary format, and for which additional human intervention to produce a similar item for additional customers is minimal.
- B. Some potential rules
 1. In determining whether a product requires minimal human intervention, the definition only looks to the supplier of the service, without regard to any human intervention on the side of the user (e.g. where the user may input certain parameters into an automated system to obtain a customized result).

Furthermore, the definition focuses on the provision of the product and therefore does not include human effort in creating or supporting the system, such as setting up the system environment needed for the provision of the product, maintaining and updating the system environment, dealing with system errors, or making other generic, non-specific adjustments unrelated to individual user requests. Finally, the threshold of minimal human intervention would not be crossed where the provision of the product to new users involves very limited human response to individual user requests / input or where in individual cases involving particular, more complex problems, the program running the system directs the customer to a staff member.

 - a. The text is based on United Nations Model Double Taxation Convention Between Developed and Developing Countries (2021) ¶ 54 and OECD, “Tax Challenges Arising from Digitalisation – Report on Pillar One Blueprint: Inclusive Framework on BEPS,” Box 2.2.
 2. An indicator of an “automated digital product” is the ability to scale up and provide the same type of product to new users with minimal human intervention. This aspect aims to identify products that benefit from significant economies of scale, rather than to suggest that there is no human intervention required. For many businesses with automated digital products, developing the system that delivers the product may require a large degree of upfront human effort and capital inputs (such as creating algorithms to deliver the automated product, including tailoring the offering to the user’s preferences). The definition distinguishes products by looking to whether the marginal cost in terms of additional human effort to provide the same product to additional users is nil or almost nil. In other words, after the product is developed (such as the music catalogue or social media platform), the business can provide that product to one user or to many users with the same basic process; whereas a business with a nonautomated product would see a proportionate increase in the costs per unit in connection with providing the services to new customers.
 - a. The text is based on United Nations Model Double Taxation Convention Between Developed and Developing Countries (2021) ¶ 54 and OECD, “Tax Challenges Arising from Digitalisation – Report on Pillar One Blueprint: Inclusive Framework on BEPS,” Box 2.2.

3. An item is provided for commercial use when it is furnished to a commercial enterprise for exclusive use by the commercial enterprise.
 - a. The text is based on Iowa Code § 432.3 (104). See also Iowa Administrative Code § 701-225.8 for possible expansion of the explanatory text.
4. The rules could acknowledge that the taxation of some automated digital products are preempted by the Internet Tax Freedom Act.

C. Examples – suggested outcomes

1. The publication or public performance of a copyrighted work in a digital format for a fee would generally constitute the sale of an automated digital product. Examples include the sale of downloaded digital books or music, the sale of music or video streaming service subscriptions, the sale of digital access to a live-streamed event, 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 an automated digital product.
2. But, an online seminar in which the customer can ask questions and receive feedback during the seminar would not be an “automated digital product” because the human intervention in providing the product for individual customers would be more than minimal. See, Value Added Tax Committee Working Paper No. 919 § 3.1.3 (2017).
3. 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 an automated digital product because the title opinion is customized for each individual customer by the attorney. See, Value Added Tax Committee Working Paper No. 919 § 3.1.5 (2017).
4. But, the online supply of legal contract templates which are customized to the purchaser’s needs in an automated manner pursuant to data input by the purchaser (for example, if the customer requires a ‘data protection’ clause in the contract, the customer selects that option and the supplier’s system automatically retrieves the relevant clause and includes it in the contract template) would be an “automated digital product.” See, Value Added Tax Committee Working Paper No. 919 § 3.1.5 (2017).

D. Explanation

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 will expand the tax base, since digital products often have distinct attributes that justify distinct tax treatment.

The proposed definition has three criteria with three objectives. The first criterion is that the item must be in a binary format, specifically including software and service. Binary format is the basic characteristic of a product that is digital. The reference to software and services is not an essential element of the definition, but has been added to explicitly eliminate the arbitrary distinction between software and services.

The second criterion requires noncommercial use. Digital items furnished to a commercial enterprise for exclusive use by the commercial enterprise are excluded. 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 third criterion requires minimal human intervention by the service provider. 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.

E. Commentary

1. The concepts of “minimal human involvement” and “minimum human intervention” are used in:
 - a. the definition of “automated digital service” in the [United Nations Model Double Taxation Convention Between Developed and Developing Countries \(2021\)](#) ¶ 5.
 - b. the definition of “automated digital service” in the [OECD, “Tax Challenges Arising from Digitalisation – Report on Pillar One Blueprint: Inclusive Framework on BEPS”](#) (2020) Box 2.1, and
 - c. the definition of “electronically supplied service” in the [Council of the European Union Implementing Regulation No. 282/2011](#) (2011) Article 7.
2. We will not be starting from scratch. These organization have applied these concepts to various situation. We can use their guidance as reference material for interpreting “minimal human intervention.” E.g.:
 - a. [United Nations Model Double Taxation Convention Between Developed and Developing Countries](#) (2021) ¶ 53, 54.
 - b. [OECD, “Tax Challenges Arising from Digitalisation – Report on Pillar One Blueprint: Inclusive Framework on BEPS”](#), Box 2.2
 - c. [Value Added Tax Committee Working Paper No. 843](#) (2015).
 - d. [Value Added Tax Committee Working Paper No. 896](#) (2016).
 - e. [Value Added Tax Committee Working Paper No. 919](#) (2017).
 - f. [Value Added Tax Committee Working Paper No. 990](#) (2020).

3. The “minimal human intervention” threshold differs from Washington’s “digital automated services” threshold, which excludes “any service that *primarily* involves the application of human effort by the seller.” Washington RCW 82.04.192(3)(b) (emphasis added).
4. The definition of “automated digital product” would include some services preempted by the Internet Tax Freedom Act, and no allowance is made for the preemption. A state statute should not lock in the federal preemption, which has not been definitively litigated, and which could change. Furthermore, some Internet access services are not preempted. E.g., Internet access by a provider that does not offer screening software to limit access to minors. The nuances of the federal preemption are better addressed in state regulations, which can be amended as circumstances change.
5. Unlike the United Nations definition of “automated digital service,” the OECD definition of “automated digital services,” the European Union definition of “electronically supplied services,” and the Streamlined Sales Tax definitions for “specified digital products,” the definition of “automated digital product” does not require that the product be delivered electronically, or over the Internet or other electronic network. Delivery over the Internet should not be a criterium because it will further implicate the Internet Tax Freedom Act.
6. A state could narrow the application of the definition of “automated digital product” by taxing only specific types of automated digital products, or by excluding specific types of automated digital products. Possibly, the work group could articulate specific inclusions or exclusions that states could consider.
7. A state could separately tax digital products that are not automated.