

## Proposed Model Digital Product Definition and Related Exemption – 20250324 Draft

The following proposed statutes and regulations are presented to the digital products definition study group for possible use in the whitepaper being drafted by the MTC digital products work group. While not all-inclusive, the proposal defines a broad range of digital products and an exemption if the digital products are sold for use in a trade or business.

### A. Statutory provisions

1. The state sales and use tax imposition statute would include the sale or use of an “automated digital product” defined as follows: “Automated digital product” - an item, including software or a service, that is provided in a binary format, and for which additional human intervention required to produce the same or a substantially similar item for additional customers is minimal.
2. Exemption: A product is exempt from taxation as an automated digital product if the product will be used predominantly for a trade or business.

### 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 human effort to provide the product and therefore does not include human effort in creating or supporting the system by which the item is provided, 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 same or similar product to new users generally requires 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.

Source - The text is based on [United Nations Model Double Taxation Convention Between Developed and Developing Countries \(2021\)](#) Commentary on Article 12B ¶ 53 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 involvement required in the business. 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 or substantially similar 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 product to new customers.

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3. The rules could acknowledge that the taxation of some transactions involving automated digital products may be preempted by the Internet Tax Freedom Act.

### C. 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, prompting some states to tax software by treating it as tangible personal property or by specifically including it in the tax base. 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 taxable items. In other cases, the classification will expand the tax base in recognition that digital products have distinct attributes that justify distinct tax treatment.

One criterion for the proposed definition is that the item must be in a binary format, specifically including products that may also be software or services. Binary format is the current, basic characteristic of a product that is digital. If a state wanted to future-proof the definition for quantum computing, it could add "qubit format" as an addition format. The reference to software and services is not an essential element of the definition, but has been added to explicitly eliminate the boundaries of software and services.

A second criterion considers the degree of human effort or intervention by the service provider to provide the product for use by other customers. 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.

A third criterion, expressed as an exemption, is that the automated digital product be used predominantly for a trade or business. The term "trade or business" is used in federal Internal Revenue Code and Treasury Regulations, and federal interpretations could be used for guidance. The objective of the exemption is to prevent the pyramiding of taxes. The criterion is drafted as an exemption because it depends upon the use of

the product, a characteristic that is determined by the buyer. Thus, the buyer will need to claim the exemption.

The business purpose exemption is an essential complement to the definition of “automated digital product” because the exemption eliminates the taxation of transactions traditionally treated as the nontaxable sale of intangible rights, such as the sale of digital publishing or performing rights. Section 332 of the Streamlined Sales Tax Agreement achieves a similar result for the taxation of “specified digital products” by only imposing the tax on an “end user” unless specified otherwise. Under the Agreement, an “end user” includes any person other than a person who receives by contract a product for further commercial broadcast, rebroadcast, transmission, retransmission, licensing, relicensing, distribution, redistribution or exhibition of the product, in whole or in part, to another person or persons.

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 tangible storage media such as compact discs. However, the sale of publishing or performance rights to a business would be exempt.

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 a particular interpretation of a federal preemption, which has not been definitively litigated, and which could change. Furthermore, some Internet access services are not preempted. For example, the taxation of Internet access is not preempted if the provider 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.

Unlike the Streamlined Sales Tax Agreement definitions for “specified digital products,” the definition of “automated digital product” does not require that the product be transferred electronically. Electronic transfer, presumably over the Internet, should not be a criterion because it will further implicate the Internet Tax Freedom Act.

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.

A state could separately tax digital products that are not automated.

#### D. Critique

##### 1. Clarity

In many cases, the determination of minimal human intervention will be clear. But, the concept could be difficult to apply in some situations. In those situations, states could look to guidance from organizations that have used the concept in other contexts, including:

- the definition of “automated digital service” in the [United Nations Model Double Taxation Convention Between Developed and Developing Countries](#) (2021) Article 12B ¶ 5.

- 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
- the definition of “electronically supplied service” in the [Council of the European Union Implementing Regulation No. 282/2011](#) (2011) Article 7.

States would not be bound by published guidance, but could use published guidance as reference material for interpreting “minimal human intervention.” E.g.:

- [United Nations Model Double Taxation Convention Between Developed and Developing Countries](#) (2021) Commentary on Article 12B ¶¶ 53, 54.
- [OECD, “Tax Challenges Arising from Digitalisation – Report on Pillar One Blueprint: Inclusive Framework on BEPS”](#), Box 2.2
- [Value Added Tax Committee Working Paper No. 843](#) (2015).
- [Value Added Tax Committee Working Paper No. 896](#) (2016).
- [Value Added Tax Committee Working Paper No. 919](#) (2017).
- [Value Added Tax Committee Working Paper No. 990](#) (2020).

Examples:

- 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).
- 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).
- A supply of services by a website providing automatic search and filter functions for dating purposes stays within the limits of “minimal human intervention.” However, if individual advice/assessment of the chances to succeed in the relationship/etc., is performed by a human being at the request of the customer, “minimal human intervention” is exceeded. Where the consideration paid includes the automatic search and the possibility for the customer to have individual assessment, then this is not an automated digital product, even if the customer does not use this possibility of individual assessment. Where there are two different services, with different considerations, the automatic search service will be an automated digital product and the search service that includes a human assessment will not be an automated digital product. See, Value Added Tax Committee Working Paper No. 919 § 3.1.5 (2017).
  - A state’s bundling rules might require a different outcome. For example, if the automated search function and the human assessment were sold for one non-itemized price, and it was determined that the functions were distinct and identifiable, and one function was not essential to the other, a state bundling rule might unbundle the transaction.

## 2. Revenue generation and prevention of erosion of the tax base.

The proposed definition of an automated digital product is broad, but would exclude many products that are produced by humans and delivered in a digital format.

Nevertheless, these provisions should generate more revenue than the revenue generated by the taxation of “specified digital products” under the Streamlined Sales Tax Agreement.

The “minimal human intervention” criterion makes the proposed tax definition narrower than Washington’s tax on “digital automated services,” which taxes “any service transferred electronically that uses one or more software applications,” but excludes “any service that *primarily* involves the application of human effort by the seller.” Washington RCW 82.04.192(3)(b) (emphasis added).

As more products become automated, particularly with the development of applications generated by artificial intelligence, the proposed tax base may actually expand.

### 3. Synchronization with other tax provisions including bundling.

The proposed definition is intended to be compatible with the selective tax systems of the many states that do not broadly tax professional services. If human professionals are involved in providing the digital product to individual customers, the product will not be included in the tax base as an automated digital product.

The proposed definition may overlap with existing definitions of taxable tangible personal property and taxable services. For example, a compact disc of recorded music would be tangible personal property and an automated digital product. A music “streaming service” may be a taxable service and an automated digital product. The overlap should be inconsequential if the tax rate is the same.

The exemption for predominant use in a trade or business is limited to the sale of products as automated digital products, and is not intended as an expansion of the exemption to the sale of other types of taxable items. For example, if the sale of an automated digital product used in a trade or business would be taxable in a state as the non-exempt sale of tangible personal property or the non-exempt sale of a taxable service, it would remain taxable.

The bundling or unbundling of products by a producer is likely to be determined by economic or marketing considerations. However, the addition of automated digital products to the sales tax base may motivate some providers to combine automated products with non-automated products so that the combined product will have more than minimal human intervention. Accordingly, a state’s bundling rules should be reviewed.

The Streamlined Sales Tax Agreement Library of Definitions defines a “bundled transaction” as “the retail sale of two or more products, except real property and services to real property, where (1) the products are otherwise distinct and identifiable, and (2) the products are sold for one non-itemized price.” Because the definition refers to “products,” the general definition should be applicable to “automated digital products.” Section 330 of the Agreement provides that member states “are not restricted in their tax treatment of bundled transactions except as otherwise provided in the Agreement.”

Part C of the Streamlined definition of “bundled transaction” could be problematic because it refers to “tangible personal property” and “services,” with the term “services” being undefined in the Agreement. An “automated digital product” is a separate classification that is not dependent upon the product being tangible personal property or a service. However, it may be assumed that an “automated digital product” is either tangible personal property or a service, such that Part C applies.

If a state has exemptions that are limited to tangible personal property or taxable services, the state should consider expanding the exemptions to explicitly cover automated digital products.

#### 4. Pyramiding of taxes.

There should be little pyramiding of taxes because an automated digital product is exempt if the product will be used predominantly for a trade or business. Since the exempt use is determined by the customer, the customer will have to declare the exempt use by using existing state procedures, such as submitting an exemption certificate. In addition, the need for customers to provide documentation to sellers could be reduced by a state through the use of rebuttable presumptions for products that would only have a business purpose.

#### 5. Sourcing

The exemption for automated digital products that will be used predominantly for a trade or business should reduce sourcing difficulties that may result from commercial transactions that involve multiple business users at multiple locations. However, depending upon the state, sourcing may need to be clarified or specified. The general sourcing rules in section 309 of the Streamlined Sales Tax Agreement should be sufficient because the sourcing rules apply to “all sales regardless of the characterization of a product as tangible personal property, a digital good, or a service.”