

May 8, 2025

Via E-Mail @ ray.langenberg@cpa.texas.gov.

Ray Langenberg
Chair, MTC Digital Products Definitions Study Group
444 North Capitol Street NW, Suite 425
Washington, DC 20002

Re: Proposed Model Digital Product Definition and Related Provisions

Dear Ray:

We are writing to share our comments regarding the proposed model definition of a digital product. Specifically, we write to describe our concerns with the MTC's April 16, 2025, draft proposal ("Draft Proposal"), which provides a proposed statutory definition of an automated digital product ("Proposed Definition") and provides related interpretative provisions that would be included in the whitepaper to be drafted by the MTC digital products work group.

Draft Proposal

The Draft Proposal defines "automated digital product" as follows:

an item, including software or a service or a right to access or use the item regardless of duration, 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.

The Proposed Definition also includes a business-to-business exemption:

A product is exempt from taxation as an automated digital product if the product will be used predominantly for a trade or business.

Comments on Draft Proposal

In our view, there are four primary issues with the Proposed Definition and the related interpretative provisions.

First, the Proposed Definition of an "automated digital product" references "software *or* a service." In some states, software is included in the definition of tangible personal property, and, depending on how it is accessed or delivered, software may be subject to sales tax.

Second, the proposed definition requires that the amount of additional human intervention required to produce the same or a substantially similar item for additional customers be “minimal.” This requirement is unworkable because “minimal” is not defined and ambiguous. It is an invitation for disputes.

Third, in addition to the ambiguity noted above, the definition requires an analysis of the provider’s service to determine “minimal human intervention.” This approach runs afoul of how states determine characterization using the true object and some sales tax exemptions.

Fourth, the use of “binary format” will limit the application of the Proposed Definition to existing technologies and should be eliminated.

We describe each of these issues in more detail below.

1. The Proposed Definition May Lead to Unintended Consequences.

The scope of the Proposed Definition includes “software.” However, a majority of states include prewritten or “canned” computer software within the definition of tangible personal property.¹ Including software in the definition of “automated digital product” will require other legislative changes to address the overlap.

Additionally, the inclusion of software in the Proposed Definition may cause an unintended tax base expansion or result in a conflict with other defined terms. For example, Maine law includes “any computer software that is not a custom computer software program” within its definition of tangible personal property.² In contrast, Connecticut taxes canned software as tangible personal property while custom software is taxed as a computer and data processing service.³ Thus, we recommend excluding software from the Proposed Definition.

2. Requiring “Minimal” Human Intervention is Unworkable Because Minimal is Not Defined.

The Proposed Definition provides that in order for an item to be considered an “automated digital product,” the “additional human intervention required to produce the same or a substantially similar item for additional customers” must be “minimal.” Determining whether a product requires “minimal human intervention” requires an inquiry into the amount of human effort required to provide the product. But the term “minimal” is not defined – leaving a gaping hole in the Proposed Definition. The Draft Proposal suggests that, in cases in which the “minimal” concept is difficult to apply, states could look to guidance from organizations

¹ See e.g., Conn. Gen. Stat. § 12-407(a)(13), Idaho Code § 63-3616(b), Mich. Comp Laws § 205.51a(r); see generally, Streamlined Sales and Use Tax Agreement, Appendix C, Part I (Administrative Definitions) (requiring member states to define “tangible personal property” as including “prewritten computer software”) Appendix C, Part II (Product Definitions) (defining “prewritten computer software” and other computer related terms, but permitting member states to exempt “prewritten computer software” “delivered electronically” or by “load and leave”).

² 36 ME Rev. Stat. § 1752 (17).

³ Conn. Gen. Stat. § 12-407(a)(13), (a)(37)(A).

that have used the concept in other contexts. However, this suggestion frustrates the purpose of a model definition - to provide a uniform definition that makes administration by states and compliance by businesses predictable and uniform. By not defining the term “minimal” the Proposed Definition leaves it up to states to determine how to interpret the term which can create confusion and inconsistent treatment.

3. Considering the Perspective of the Service Provider Contradicts “True Object” and Certain Tax Exemptions.

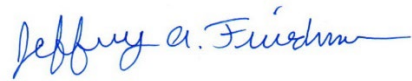
We are also concerned that, in determining whether a product requires only “minimal human intervention,” the Draft Proposal only considers the activities of the provider of the service, “without regard to any human intervention on the side of the user.” The focus on what the service provider is doing, to the exclusion of what the buyer is seeking, runs contrary to many state rules, which often look to what the purchaser is seeking in determining the characterization and taxability of a product or service. For example, in mixed transactions containing a sale of two or more products or a service, states often apply a true object or similar test to determine what the purchaser is buying. The true object test evaluates what is important to the purchaser (e.g., did the buyer seek the non-taxable service or the taxable tangible personal property included with the service?). Also, several common sales tax exemptions are dependent on a purchaser’s (not the seller’s) intentions. For instance, resale exemptions and manufacturing exemptions require consideration of a purchaser’s – not seller’s – intention. The Study Group should consider the application of the true object test – and sales tax exemptions - in the approach contained in the Draft Proposal.

4. “Binary Format” Limits the Useful Life of the Proposed Definition.

Technology continues to evolve. The Proposed Definition’s use of the term “binary format” may make sense today, but could limit the application of the Proposed Definition in the future. As an example, quantum computing – which is in its infancy – does not rely on binary data. The Study Group should consider replacing “binary format” with “transferred electronically” to allow for future technological developments.

We appreciate the Study Group's efforts and look forward to discussing these issues further.

Sincerely,



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Jeff Friedman

Charlie Kearns

Eversheds Sutherland (US) LLP

CC: Helen Hecht, Uniformity Counsel, Multistate Tax Commission