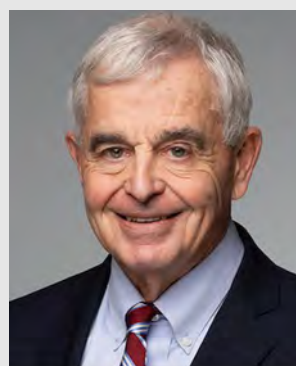


What's New in the World of AI and State Tax?

by Martin I. Eisenstein and Joseph Caissie



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In this installment of Eyes on E-Commerce, Eisenstein and Caissie examine the latest application of state tax laws to artificial intelligence.

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On a daily basis, we can read about how artificial intelligence will be transforming our economy and changing our business and personal lives. Many of us have used ChatGPT and other programs to obtain information, draft poems, or write music, but we can assure our readers that we did not use it to draft this article.

Back in the midst of the COVID-19 pandemic in 2020 we wrote two articles to discuss the application of state tax laws to AI.¹ In this article we revisit this subject, in light of new

¹ Martin I. Eisenstein, Michael Carey, and Jamie E.T. Szal, "Alexa, Is AI Taxable?" *Tax Notes State*, May 11, 2020, p. 719; Eisenstein, Szal, and Carey, "Hey Siri, What About Income Taxes on AI?" *Tax Notes State*, June 8, 2020, p. 1187.

developments in AI technology and various states' extensions of their sales tax laws to services previously not taxed. Do these new laws apply to AI, either as we discussed back in 2020 or today?

We were initially surprised to see that no state has imposed a sales tax or other tax on AI itself. But when we thought about it, we should not have been, given the structure of sales tax laws. AI is not one product or service, which we explore in this article as we did in our prior articles. States, as they do for other products and services, tax AI based on the type of product or service the customer purchases. Sales tax is not assessed on AI per se, but on what the customer is purchasing and whether it is deemed software (prewritten or customized), information services, data processing, or consulting services.

In 2025 three state legislatures and a tax agency expanded their laws and regulations to cover different forms of IT services and products. Some of the laws are relatively basic, such as the Louisiana statute imposing the sales tax on software as a service (SaaS) and non-proprietary information services² and the Texas regulation redefining data processing.³ The new laws in the other two states — Maryland⁴ and Washington⁵ — are, in contrast, much more comprehensive. All

² La. Rev. Stat. section 47:301.3(9) and (10). See also Louisiana Department of Revenue, "Sales and Use Tax on Digital Products and Related Services" (Aug. 2025).

³ 34 Tex. Admin. Code section 3.330 (eff. Apr. 2, 2025).

⁴ Md. Code Ann., Tax-Gen. sections 11-101(m)(14) ("taxable service" includes any "data or information technology service described under [North American Industry Classification System (NAICS)] Sector 518, 519, or 5415") and -104(l)(1). Comptroller of Maryland, Technical Bulletin No. 56 (June 10, 2025) (including data processing, data storage, and web hosting). See proposed amendments to Md. Code Regs. 3.06.01, Comptroller of Maryland, "Notice of Proposed Regulations" (Dec. 12, 2025).

⁵ Wash. Rev. Code Ann. section 82.04.050(3)(g) (eff. Oct. 1, 2025) (Wash. S.B. 5814, signed into law as ch. 422 (2025)); Washington DOR, "Information Technology, Website and Software Development Services Now Subject to Sales Tax" (July 30, 2025).

four states' amended laws may be applied to impose sales tax on various AI products and services. We discuss these legislative and regulatory developments insofar as their application to AI, using the four categories of taxable products and services outlined in our 2020 *Tax Notes* articles. But first we want to make sure we are operating from the same vocabulary, and therefore we discuss AI in the context of three typical current AI products. We have a major caveat, however: From all that we have read, we can safely bet that the scale of change in the coming years will dwarf the changes of the last five years.

What Forms Does AI Take?

The AI we reviewed in 2020 was software that could automatically detect patterns in data and spit out useful answers in a single area of inquiry. Although this AI was being integrated into more products and was increasingly automated, at the end of the day it was not much more than a sophisticated software product.

Big data centers were not always necessary to generate the results. Computers were used to store the software in the case of SaaS, and on a person's wrist in the case of a tracking device. Although the power of a computer may have been used in connection with the AI product, it was likely that the purchaser's true object in buying the product was the use of the software to generate a result.

Today AI is performing more functions at a higher level of sophistication and automation, thus requiring a combination of software and large amount of server space and GPUs to generate results.⁶ The AI products of today often use large language models (LLMs), which are neural networks of parameters developed (or "trained," in the AI vernacular) on an enormous amount of text.⁷ LLMs can generate text and images, perform complex reasoning, and solve problems posed by users. Compared with the

earlier generation of AI products that used machine learning, LLMs are much more general. The COVID-19 tracking app we discussed in our 2020 article — a type of machine learning product — was programmed to receive particular inputs of data and then perform an analysis based on those inputs. Asking an LLM a question about COVID-19, however, first involves the LLM interpreting the question (because it does not know the user is about to ask about COVID-19), processing the question through its neural net to generate a response, and finally formulating a response in language the user will understand. This entire process requires enormous computer resources and cannot be done on a user's own device.

LLMs are involved in two of the categories we describe below. We also discuss a third type of product, which is more akin to the 2020 machine learning products. In this article, we analyze these product types under each of the four sales tax categories referred to in our previous articles, with a focus on the 2025 laws likely designed to address the changing technological world.

Category 1: Generative AI Chatbots

Generative AI chatbots are what come to mind for most people when the topic of AI comes up today — the user sits in front of a screen, goes to a website, and starts typing in questions. A generative AI chatbot, which is usually based on an LLM, generates texts, guidance, references, explanations, images, and so forth in response to text or conversations with the users. That is how the chatbot referred to in recent rulings by the Illinois Department of Revenue⁸ and Indiana DOR⁹ operates. Similarly, Claude and ChatGPT — the chatbots made by Anthropic and OpenAI, respectively — operate based on the LLMs that these companies have developed. The "secret sauce" of the AI provider is its development of the LLM.

⁶ See David Maiolo, "How OpenAI's ChatGPT Achieves Its Power: A Look at the Hardware Behind the AI Language Model," David Maiolo blog, Mar. 3, 2023 (estimating the hardware necessary to respond to a ChatGPT inquiry).

⁷ See Wayne Xin Zhao et al, "A Survey of Large Language Models," arXiv:2303.18223 (2023), cited in Illinois DOR, Letter Ruling ST 25-0057-GIL (Sept. 16, 2025).

⁸ For a general description of LLMs and the customer's access to the LLM, see Illinois DOR, Letter Ruling ST 25-0057-GIL, *supra* note 7.

⁹ Indiana DOR, Rev. Rul. No. 2025-02-RST (July 23, 2025).

An AI chatbot user typically accesses the AI product by an internet or application programming interface connection.¹⁰ The message from the user is conveyed to servers located in data centers located in the cloud. A large amount of hardware, such as memory cards, GPUs, and processors, is necessary to receive and interpret the message from the user, generate a response, and convey the response to the customer.¹¹

LLMs are much more general and versatile than the AIs of 2020. A purchaser of a subscription may have multiple purposes in doing so. The purchaser can ask an LLM for mortgage advice or for sonnet writing. Even within the category of mortgage advice, the level of service LLMs can provide can vary widely. Claude can give basic advice, the way a mortgage broker or a search engine might: “Refinance if you plan to stay in your home longer than five years and current rates are at least 1 percent below your existing mortgage.” It can also write code to run a simulation that determines how often a precise decision on refinancing winds up profitable. It can even help develop and market an app that can be sold to consumers considering refinancing.

Category 2: Machine Learning Products Requiring the Provider to Use Its Own Servers/Personnel to Respond

The precursor to LLMs was more specific machine learning algorithms. These were trained in a similar way to LLMs, but on a single task, such as playing chess or recognizing fraudulent transactions. These more specific products are sometimes small enough to not need the use of remote servers. They are not necessarily developed by the OpenAIs of the world, but could even potentially be developed in-house for a specific purpose for a single company.

We focus on one variety: a fraud-detecting program with one part embedded in an online retailer’s order servers to collect data about transactions. It feeds data to the tech company,

¹⁰ As a variation, an interface can live locally on the customer’s computer, such as Microsoft Copilot, but the local software calls out to the cloud and accesses the power of the data center servers and their GPUs to generate the responses. A mini-LLM can also live entirely on a user’s machine, which will likely become more common as the technology improves.

¹¹ See Maiolo, *supra* note 6.

which uses its machine-learning-trained model to analyze the transactions on its own servers, monitored by its employees, and then gives its customer (the retailer) information about whether a given transaction is fraudulent and the device that the retailer’s customer used.

Category 3: Sale to Businesses That Incorporate AI in the Package They Sell to Their Customers

A company may provide services that use a cloud-based LLM to provide the service. For example, a company may provide language classes that call on ChatGPT to provide practice conversations for its users or tutoring sessions. Or a company can use an LLM to provide a virtual assistant that transcribes meetings, combs through various apps to answer questions about workflow, and does research.

Tax Characterization: SaaS

In 2025 Louisiana joined the 20 other states that tax SaaS.¹² As is generally true in the other states, under the new Louisiana law it is not merely the sale or license of prewritten software that is taxable, but what is taxable under the new law is also the “providing of prewritten computer software access services,” which is defined as “the right to access and use prewritten computer software, where possession of the software is maintained by the seller or third party.”¹³ Tennessee similarly provides for sales tax on the “use of computer software,” which is defined as “the access and use of software that remains in the possession” of the provider.¹⁴

The preliminary question is whether the LLM is software. The Streamlined Sales and Use Tax Agreement defines software as “a set of coded instructions designed to cause a ‘computer’ or automatic data processing equipment to perform

¹² The states that tax SaaS, in addition to Louisiana, are Arizona, Connecticut, Hawaii, Iowa, Kentucky, Maryland, Massachusetts, Mississippi, New Mexico, New York, Ohio, Pennsylvania, Rhode Island, South Carolina, South Dakota, Tennessee, Texas, Utah, Vermont, Washington, and West Virginia. In addition, the District of Columbia and Chicago impose a sales tax on SaaS products used in their jurisdictions. Some states, such as Iowa, exempt sales of SaaS to businesses, and other states, such as Texas, effectively charge a reduced sales tax rate on the charges for SaaS.

¹³ La. Rev. Stat. section 47:301.3(9).

¹⁴ Tenn. Code Ann. section 67-6-231(a) and (b).

a task.”¹⁵ The LLM, therefore, likely is software: It contains elements of more traditional software like lines of code, and its core is a neural net that maps how closely related various concepts are to each other.¹⁶ The neural net is a set of coded instructions that allows the LLM to perform the task of responding to users’ questions.

That the LLM itself is likely software is not the end of the inquiry, though. States typically use the true object test to categorize a transaction.¹⁷ Is the user purchasing use of the LLM? Or is the buyer purchasing the responses it gets from the LLM, which the user can receive only via the operation of the LLM on powerful hardware maintained by the provider? The fact that the interface is a simple, generic text window certainly makes it *seem* less like the user is using software — for example, there is not a spreadsheet, like with Excel. The neural net is on the back end, requiring significant computing power. The user is just asking questions and getting answers in real time. Behind the curtain, the provider must receive the input in plain language, tokenize the request to be able to feed the information to an LLM, which then operates on large servers and GPUs to generate a response, and then conveys the response to the user. These servers and data centers also have dozens or even hundreds of human employees who monitor the operation.¹⁸ Is this soup to nuts process mere use of software, or something more, such as data processing, data analytics, or an information service?

The only two states to address the taxability of generative AI chatbots are Indiana and Illinois. The Indiana DOR concluded that an AI chatbot offered through web access or an application programming interface is a nontaxable service and not the sale or lease of software.¹⁹ To be sure, as the DOR acknowledged, Indiana does not tax SaaS. And without analysis of what a customer of

generative AI chatbot services is purchasing, the Illinois DOR concluded that the chatbot provider was providing SaaS.²⁰ Because Illinois does not tax SaaS, the DOR did not have to take the next step of determining whether what the customer was purchasing was SaaS or another service. But that is an exercise that should be undertaken in the 21 states that do tax SaaS.

So the question, which neither the Illinois DOR nor the Indiana DOR directly addressed, is: What is the true object of the purchase? In Letter Ruling 18-09, the Tennessee DOR noted that while the customer had access to the taxpayer’s software that collects data about the customer’s website, the customer’s use of the software was “merely incidental to the true object” of the taxpayer’s offerings.²¹ Thus, even though Tennessee taxes SaaS, the DOR concluded that the customer was purchasing nontaxable data analytics services.²² However, in other letter rulings, the Tennessee DOR²³ and the Rhode Island DOR²⁴ found that the true object of the transaction was access to the software.

Our takeaway, as we described in a previous article in *Tax Notes State*,²⁵ is that a determination of whether the sellers of generative AI chatbots are providing SaaS (use of the provider’s software), a data processing service (generation of the response by a combination of software and computer resources), or an information service (providing the answers to the customer’s request) should be based on all the facts and circumstances of how the provider is marketing the product and how its customers are using the product, and not simply turn on whether the chatbot is software. In addition, the fact that the purchaser of the chatbot service cannot generate the answer on their own

¹⁵ See SSUTA, Appendix B.

¹⁶ For example, it arrives at the answer to the question “what color is the sky?” by determining that the user has asked a question about color and the sky. Its training has taught it to closely associate the concepts of “color” and “sky” with the word “blue.”

¹⁷ Eisenstein and Matthew Pick, “Tax(onomy) of Services: The True Object Test?” *Tax Notes State*, Jan. 9, 2023, p. 143.

¹⁸ See Microsoft, “Frequently Asked Questions About Our Datacenters” (undated).

¹⁹ See Indiana DOR, Rev. Rul. No. 2025-02-RST, *supra* note 9.

²⁰ See Illinois DOR, Letter Ruling ST 25-0057-GIL, *supra* note 7.

²¹ See Tennessee DOR, Letter Ruling No. 18-09 (Dec. 14, 2018).

²² See also Tennessee DOR, Letter Ruling No. 21-01 (Jan. 8, 2021) (Data analytics services that use software and an online dashboard are not taxable as cloud software because the data analytics service is the true object of the taxpayer’s data enhancement, reporting services, and dashboard services.)

²³ Tennessee DOR, Letter Ruling No. 17-15 (Nov. 9, 2017).

²⁴ Rhode Island DOR, ADV 2025-01 (The online display of ancestral and health history reports is vendor-hosted software rather than data analytics because a taxpayer could not share the ancestral and health history information with its clients if the product were not computer software.)

²⁵ Eisenstein and Pick, *supra* note 17.

equipment but requires the enormous computing power required to operate the LLM, along with human supervision and monitoring, suggests that the true object is not software. Unlike the AI of 2020, the infinite number of possible requests requires the horsepower of large servers and GPUs in order to interpret the request and produce a response.

Complicating the analysis of the true object is that there is not a single predictable inquiry categorizing a customer's purchase of a subscription. Some uses may be taxable and others may not be, thus creating a taxable service because one part of the bundle is taxable.²⁶

Regarding the second category of products, one could argue that the purpose of the program is for the provider to identify fraud based on its skill and expertise. As the Connecticut Supreme Court held in *Hartford Parkview Associates*,²⁷ although the provider of the service used computers to furnish the service to its customers, the customers' true object was the reservation service facilitated by the computers. As a general rule, if a program is located and operates largely on a customer's own machines, it is more likely to be deemed software. If, as in our example, the information gleaned by a program is instead transmitted to another location for processing, that is more likely to be deemed data processing, an information service, or some other category of product.

For the third category of products, the question is whether the product the purchaser is obtaining is in effect what the purchaser would pay to a consultant to provide tutoring or office assistance. As such, it may be treated for taxation purposes as a consulting service rather than any other category of service. We discuss consulting services in the last section of this article. The fact that the products in the second and third categories have a single use buttresses the argument that SaaS is not the true purpose.

In the recently amended Texas regulation, referred to earlier in this article, the comptroller seems to abandon the true essence or principal

object test. SaaS is deemed data processing in Texas.²⁸ The comptroller's comments on adoption of the amendment squarely reject the true essence test used by some courts to determine whether a service is data processing. The focus, according to the comptroller, should not be on the purpose or object of the transaction, but on "what the vendor is doing."²⁹ At the same time the comptroller recognizes in the rule itself that:

The manipulation of data that depends on the external knowledge and discretionary judgment of the service provider in individual applications suggests that the data processing activity is ancillary to another service and should not be taxable as a data processing service. . . . The evaluation is based on what the service provider is doing, not on what the customer wants.³⁰

The Texas test may indicate that the expertise the AI provider has developed for each of the three categories of products provides service to the customer in lieu of reliance on human intervention and may therefore constitute the type of discretionary judgment (albeit a type of AI) that the new regulation contemplates as removing from the category of taxable data processing.

Tax Characterization: Information Services

The recent Louisiana legislation also imposes sales tax on electronic data retrieval and research as well as information services delivered electronically.³¹ The new Maryland law assesses tax on online directories and databases, which appear under North American Industry Classification System (NAICS) sector 519.³² Twelve other states impose sales tax on electronically delivered information.³³ And like

²⁸ Tex. Private Letter Ruling No. 20180411151546 (Feb. 22, 2019).

²⁹ See preamble to 34 Tex. Admin. Code section 3.330.

³⁰ 34 Tex. Admin. Code section 3.330.

³¹ La. Rev. Stat. section 47:301.3(10).

³² Md. Code Ann., Tax-Gen. section 11-101(m)(14) ("taxable service" includes data or IT services described under NAICS sector 518, 519, or 5415).

³³ Connecticut, the District of Columbia, Hawaii, Iowa, New Jersey, New York, Ohio, South Carolina, South Dakota, Texas, Washington, and West Virginia.

²⁶ See *Downs Racing LP v. Commonwealth*, 196 A.3d 603 (Pa. 2018); 34 Tex. Admin. Code section 3.330(e).

²⁷ *Hartford Parkview Associates Ltd. Partnership v. Groppo*, 558 A.2d 993 (Conn. 1989).

many of the other states, Louisiana exempts from the definition of taxable information services “information gathered or compiled on behalf of a particular client, if the information is of a proprietary nature to that client and may not be sold to others.”³⁴

The AI chatbot could provide information, directly or indirectly, from a public database, which likely would be deemed an information service if it were provided as a stand-alone service. It also is likely taxable as part of a bundle of services, based on the general rule that if one of the services in a bundle sold for one price is taxable, then the entire bundle is taxable unless the portion of the charge relating to the taxable service is de minimis.³⁵

The second category of services — detecting fraud for retailers by identifying the type of device their customer is using — provides information to the purchaser, but it would likely be excluded from taxation in many states, including Louisiana, Maryland, New Jersey, New York, and Washington, because the information is not from a public database.

The third category of services does not involve requests for information or provision of information, so they are likely not to be deemed information services.

Tax Characterization: Data Processing

As discussed above, the new Maryland statute, which is effective as of July 1, 2025, taxes data and IT services and system software or application publishing services that fit within NAICS sectors 518, 519, and 5415.³⁶ This includes

data processing services, cloud computing services such as information as a service and platform as a service, streaming services infrastructure, data storage and backup services, and disaster recovery and data continuity services. It also includes information services, which we describe in the preceding section, and certain labor-based IT services, which we discuss in the next section.

The Washington statute, effective October 1, 2025, also expands the services subject to the retail sales tax to include IT services.³⁷ The DOR says IT services include data processing, network support, training, IT consulting, and network security management.³⁸

Before the adoption of the Maryland and Washington statutes, only four states and the District of Columbia taxed data processing services, although the definition of taxable data processing services varies among the states. Maryland and Washington do not define data processing services, but Connecticut taxes (at the rate of 1 percent) computer and data processing services, which are defined broadly to include “storing and filing information, retrieving or providing access to information, and providing consulting services.”³⁹ Texas defines data processing in its amended rule as “the computerized entry, retrieval, search, compilation, manipulation, or storage of data or information.”⁴⁰

For the generative AI chatbot product, a state that taxes data processing (such as Ohio or Texas) could argue that the product is data processing because it involves information retrieval. However, each of these states that tax data processing recognizes that if the use of the computer is “ancillary” or “incidental” to the main service, it is not taxable data processing.⁴¹

³⁴ La. Rev. Stat. section 47:301.3(10)(b). See also 34 Tex. Admin. Code section 3.342(5), in which Texas exempts the “sale of information that is gathered or compiled on behalf of a particular client . . . if the information is of a proprietary nature to that client and may not be sold to others by the person who gathered or compiled the information.” N.J. Stat. Ann. section 54:32B-3(b)(12), N.J. Stat. Ann. section 54:32B-2(yy), and N.Y. Comp. Codes R. & Regs. tit. 20, section 526.14(b), have similar exclusions from the definition of taxable information services. However, a recent decision of the New York Court of Appeals addressed the scope of the exclusion for customized reports that contained benchmarks to compare with the customer’s data. The benchmarks were based on data from other customers. These benchmarks were sufficient to render the reports taxable information services because the reports were not limited to the customer’s data. *Dynamic Logic Inc. v. Tax Appeals Tribunal*, No. 35 (N.Y. Apr. 17, 2025). Query whether other states would read the exemption as narrowly as did New York’s highest court.

³⁵ See 34 Tex. Admin. Code section 3.330(e).

³⁶ See Md. Code Ann., Tax-Gen. section 11-101(m)(14).

³⁷ Wash. Rev. Code Ann. section 82.04.050(3)(g).

³⁸ See Washington DOR, *supra* note 5; Washington DOR, “Services Newly Subject to Retail Sales Tax” (undated); Washington DOR, “Interim Guidance Statement Regarding Changes Made By ESSB 5814 for Information Technology Services” (Sept. 12, 2025).

³⁹ Conn. DOR Services, Policy Statement No. 2006(8) (Mar. 23, 2007); see also Conn. Gen. Stat. Ann. section 12-407(a)(37)(A); Conn. Agencies Regs. section 12-426-27(b)(1).

⁴⁰ 34 Tex. Admin. Code section 3.330(a)(1).

⁴¹ 34 Tex. Admin. Code section 3.330(a)(1)(C); Ohio Rev. Code section 5739.01(B)(3)(e).

But if not data processing, the service may be deemed SaaS, which is taxable in the states that tax data processing.

For the second category of products — charges paid to a service provider that provides a machine learning program to obtain data regarding fraud and the device used by a retailer’s customer — the argument that the retailer is paying the provider for the use of software rather than data processing or an information service is stronger if the machine learning program generates the answer while embedded on the retailer’s server rather than operating on the provider’s computers.

In addition, we do not see a credible argument that the third category of products constitutes data processing.

Tax Characterization: Consulting Services

The new Maryland law taxes “computer consulting services,” which include software, database, network, and web design, as well as IT project management. The LLMs described in category 1 can provide advice and help with any or all of these services.

The new Washington law also is limited to IT services, which are defined in a way similar to the computer systems design services taxable in Maryland. However, the law in effect before the adoption of the 2025 law taxed “digital automated services,” which are defined as “services transferred electronically that use one or more software applications.”⁴² Each of the three AI products described in this article may be deemed digital automated products.

There are only a few states that tax consulting services. A provider of these services could argue that each of the three product areas involves professional advice. Accountants’ and lawyers’ services are not generally subject to sales tax, so too can the argument be made that these three AI products should not be subject to tax.

Conclusion: When AI Products Become Artificial General Intelligence

Many writers suggest that as AI develops, it will replace the work of employees rather than merely supplement that work. We are not yet at this point — called artificial general intelligence — but that may not be in the distant future. Will states that tax staff augmentation then argue that the AI products the provider supplies are really staff augmentation, subject to a tax on the provider’s charges for this service? In other words, will states abandon, or at least supplement, their laws to tax these services as if they were provided by humans under the supervision of the client? Stay tuned. States and tax practitioners likely will need to address the sales tax implications of artificial general intelligence before long. ■

⁴²Wash. Admin. Code 458-20-15503(203).