STATE OF ARIZONA

Department of Revenue
Office of the Director
(602) 716-6090

Janice K. Brewer
Governor

John A. Greene
Director

CERTIFIED MAIL [redacted]

The Director's Review of the Decision of the Administrative Law Judge Regarding:	)	**O R D E R**
[redacted]	)	**Case No. 201000178 - S**
ID No. [redacted]	)	

On February 1, 2011, the Administrative Law Judge ("ALJ") issued a decision ("Decision") regarding the protest of [redacted] ("Taxpayer"). The Taxpayer appealed this Decision on March 3, 2011. As the appeal was timely, the Director ("Director") of the Department of Revenue ("Department") issued a notice of intent to review the Decision.

In accordance with the notice given the parties, the Director has reviewed the ALJ's Decision and now issues this order.

STATEMENT OF CASE

The Transaction Privilege and Use Tax Section in the Audit Division ("Division") of the Department audited Taxpayer for the period of February 1, 2005 through October 31, 2008, and determined that Taxpayer was taxable under the retail classification for the audit period. The Division reclassified the use tax reported by Taxpayer to transaction privilege tax under the retail classification and assessed additional transaction privilege and city taxes and interest ("Assessment"). Taxpayer protested and the matter went to hearing. The ALJ upheld the Division's Assessment and denied Taxpayer's protest.

On appeal, Taxpayer argues that it did not have substantial nexus in Arizona, that it followed administrative rules in effect during part of the audit period, and that the Assessment should be abated. The Division argues that the Assessment was proper under the circumstances.

FINDINGS OF FACT

The Director adopts from the findings of fact in the Decision of the ALJ and makes additional findings of fact based on the record as set forth below:

1. Taxpayer is a corporation headquartered in [redacted] that sells dental supplies to dentists, including Arizona dentists.

2. Taxpayer accepts orders outside of Arizona and uses common carriers for its shipments to customers.

3. Taxpayer does not own or lease real property nor maintain inventory in Arizona.

4. Taxpayer has sales representatives in Arizona who provide customer support and training.

5. The Division audited Taxpayer for the period of February 1, 2005 through October 31, 2008 ("Audit Period").

6. During the Audit Period, Taxpayer had six sales representatives located in Arizona.

7. Taxpayer reported use tax on its transactions with Arizona customers for the Audit Period.

8. The Division determined that Taxpayer should have paid transaction privilege tax rather than use tax.

9. On May 14, 2009, the Division issued the proposed Assessment of [redacted] additional tax plus interest. No penalties were assessed.

10. Taxpayer received notice of the Assessment on May 26, 2009.

11. On July 7, 2009, the Division received Taxpayer's protest of the state and county tax portion of the Assessment in the amount of [redacted] tax plus interest. Taxpayer submitted a letter with the protest in which it stated that it agreed with the assessment of [redacted] for program city taxes.

12. Taxpayer did not pay the unprotested portion of the Assessment at the time of filing the protest and does not claim to have paid that portion subsequently.

13. Taxpayer submitted a request for a formal hearing and an amended protest dated July 31, 2009, amending its protest to include the entire Assessment of [redacted] tax plus interest.

14. Taxpayer again submitted a request for a formal hearing, dated November 2, 2009.

15. A formal hearing was scheduled for January 12, 2011.

16. By letter of January 10, 2011, Taxpayer informed the ALJ and the Division that it would not attend the formal hearing and requested that the ALJ render a decision based on the submitted documents. Taxpayer stated that the City of [redacted] was auditing Taxpayer's customers, alleging they resold Taxpayer's products, and that Taxpayer would likely file a request for refund of all use tax paid.

17. Taxpayer did not appear at the formal hearing.

18. The ALJ determined that Taxpayer's activities created substantial nexus with Arizona for the Audit Period and were properly transaction privilege taxable.

CONCLUSIONS OF LAW

The Director adopts from the conclusions of law in the Decision of the ALJ and makes additional conclusions of law as follows:

1. A taxpayer may apply for a hearing, correction or redetermination of a proposed assessment by a petition in writing within forty-five days after the notice required by A.R.S. § 42-1108(B) is received, or within such additional time as the Department may allow, and if only a portion of the deficiency assessment is protested, all unprotested amounts of tax, interest and penalties must be paid at the time the protest is filed. A.R.S. § 42-1251(A).

2. Arizona Administrative Code (A.A.C.) Rule 15-10-107(A) provides that a petition regarding taxes other than individual income tax is timely filed with the Department if it is filed as prescribed in the Code within forty-five days after the taxpayer receives the tax assessment or refund denial from the Department.

3. Pursuant to A.R.S. § 42-1251(B), if the taxpayer does not file a petition for hearing, correction or redetermination within the forty-five day period provided by A.R.S. § 42-1251(A), the amount determined to be due becomes final at the expiration of that period, and the taxpayer is deemed to have waived and abandoned the right to question the amount unless the taxpayer pays the total deficiency assessment and then files a claim for refund within six months of payment or within the general time limits for refund claims prescribed by A.R.S. § 42-1106.

4. Although, pursuant to A.A.C. Rule 15-10-108(A), a petition for hearing may be supplemented or amended at any time before the hearing, a taxpayer cannot amend a petition to protest a portion of an assessment that has become final.

5. Taxpayer's protest of the state and county tax portion of the Assessment in the amount of [redacted] tax plus interest was timely.

6. Under A.R.S. § 42-1251(B), the unprotested city tax portion of the Assessment of [redacted] tax plus interest became final once the forty-five day protest period expired for the Assessment that Taxpayer received on May 26, 2009.

7. Taxpayer's amendment of the protest by letter dated July 31, 2009 was untimely for purposes of protesting the city tax portion of the Assessment of [redacted] tax plus interest.

8. For the transaction privilege tax to be imposed, a taxpayer must have "substantial nexus" with the taxing state, which requires a physical presence in the state. *See Quill Corp. v. North Dakota*, 504 U.S. 298, 309-317, 112 S.Ct. 1904, 1911-1916 (1992).

9. The crucial factor governing nexus is whether the activities performed in Arizona on behalf of a taxpayer are significantly associated with the taxpayer's ability to establish and maintain a market in this state. *See Tyler Pipe Industries, Inc. v. Washington Dep't of Revenue,* 483 U.S. 232, 250, 107 S.Ct. 2810, 2821 (1987).

10. A taxpayer that maintains no office or employees in the state, and that solicits business through independent contractors, may still have the requisite nexus with Arizona for imposition of the transaction privilege tax. *See Arizona Dep't of Revenue v. O'Connor, Cavanagh, Anderson, Killingsworth & Beshears, P.A.*, 192 Ariz. 200, 206-207, 963 P.2d 279, 285-286 (App. 1997).

11. A retail transaction privilege tax does not require a higher level of nexus with the taxing state than does a use tax. *See Arizona Dep't of Revenue v. Care Computer Systems, Inc.,* 197 Ariz. 414, 416, 4 P.3d 469, 471 (App. 2000).

12. The former A.A.C. Rules 15-5-2306 through 15-5-2308[1] did not prevent the Department from assessing transaction privilege tax against a taxpayer that does not maintain a place of business within Arizona. S*ee Arizona Dep't of Revenue v. Care Computer Systems, Inc.*, 197 Ariz. 414, 418-419, 4 P.3d 469, 473-474 (Ct.App. 2000).

13. Taxpayer had a physical presence in Arizona during the Audit Period through its sales representatives located in the state.

14. The activities performed by Taxpayer's representatives on Taxpayer's behalf in the state were significantly associated with its ability to establish and maintain a market in Arizona during the Audit Period.

15. Taxpayer also maintained a market in Arizona by performing its contracts with Arizona customers. *See Interlott Technologies, Inc. v. Arizona Dep't of Revenue*,

[1] A.A.C. Rules 15-5-2306 through 15-5-2308 were repealed effective August 6, 2005, and they related to a distinction between sales tax and use tax and to the question of when a transaction was subject to either tax.

205 Ariz. 452, 457, 72 P.3d 1271, 1276 (App. 2003), citing *O'Connor*, 192 Ariz. at 206, 963 P.2d at 285.

16. Taxpayer had transaction privilege tax nexus in Arizona during the entire Audit Period.

17. The assessment of transaction privilege tax against Taxpayer does not constitute a new interpretation of the law under A.R.S. § 42-2078.

18. A.R.S. § 42-5061 ("retail classification") imposes transaction privilege tax on the business of selling tangible personal property at retail. The tax base is the gross proceeds of sales or gross income derived from the business.

19. "Selling at retail" means a sale for any purpose other than for resale in the regular course of business. A.R.S. § 42-5061(V)(3).

20. All gross proceeds of sales and gross income derived by a person from business activity classified under a taxable business classification is presumed to comprise the tax base for the business until the contrary is established. A.R.S. § 42-5023.

21. If a person is engaged in the business of selling tangible personal property at both wholesale and retail, the retail transaction privilege tax applies to the gross proceeds of all sales unless the person's books are kept so as to show separately the gross proceeds of wholesales and retail sales. See A.R.S. § 42-5061(H).

22. Taxpayer did not establish that any of its sales to Arizona dentists were sales for resale.

23. The ALJ properly denied Taxpayer's protest.

DISCUSSION

Taxpayer is requesting the review of the ALJ's Decision, which upheld the Assessment. Neither of the parties makes any argument with regard to the timeliness of Taxpayer's protest. Taxpayer received notice of the Assessment on May 26, 2009, and protested only

the state and county tax portion of the Assessment in the amount of [redacted] tax plus interest on July 7, 2009. The forty-five day period for a timely protest pursuant to A.R.S. § 42-1251(A), A.A.C. Rule 15-10-107(A) ended on July 10, 2009. The city tax portion of the Assessment of [redacted] tax plus interest was unprotested at that time. That portion of the Assessment therefore became final pursuant to A.R.S. § 42-1251(B), and Taxpayer is deemed to have waived and abandoned the right to question the amount unless it pays the total deficiency assessment and then files a claim for refund within six months of payment. See A.R.S. § 42-1251(B). Taxpayer's amendment of the protest by letter dated July 31, 2009 was untimely for purposes of protesting the city tax portion, and only the state and county tax portion of the Assessment in the amount of [redacted] tax plus interest was timely protested.

Taxpayer argues that based on administrative rules in effect at the beginning of the Audit Period, it was only subject to use tax, but not to transaction privilege tax. Taxpayer further argues that the Assessment should at least be abated for that portion of the Audit Period during which those administrative rules were in effect.

According to Taxpayer's description of its business, it employed sales representatives whose Arizona activities were focused on customer satisfaction and who helped the customers integrate Taxpayer's products into their dental practice. In its protest letters, Taxpayer argues that its sales representatives do not carry inventory or take any orders in the state, and that their activities are not significantly associated with Taxpayer's ability to establish a market in Arizona.

The Division argues that Taxpayer had substantial nexus with Arizona because it had multiple employees located in Arizona and because Taxpayer's Arizona activities were intended to establish and maintain a market in the state. The Division, citing *Care Computer Systems*, 197 Ariz. at 419, 4P.3 at 474, also argues that the Department's former administrative rules did not indicate that a taxpayer without a place of business in Arizona was never subject to the transaction privilege tax.

The issue is whether Taxpayer had sufficient Arizona nexus during the Audit Period to be transaction privilege taxable on its receipts from transactions with Arizona customers.

The nexus with a taxing state of a taxpayer that maintains no office in the state, but that utilizes sales representatives, has been addressed by the U.S. Supreme Court as well as the Arizona Court of Appeals. Although the Supreme Court requires a physical presence as a prerequisite of "substantial nexus," *see Quill*, 504 U.S. at 309-317, 112 S.Ct. at 1911-1916, it found the requisite nexus for imposition of a gross receipts tax on a taxpayer who maintained no office, owned no property and had no employees residing in the taxing state, but who utilized independent contractors as sales representatives in the state. *See Tyler Pipe*, 483 U.S. at 249-251, 107 S.Ct. at 2821-2822. The Court stated:

> [T]he crucial factor governing nexus is whether the activities performed in this state on behalf of the taxpayer are significantly associated with the taxpayer's ability to establish and maintain a market in this state for the sales.

Tyler Pipe, 483 U.S. at 250, 107 S.Ct. at 2821. The 1944 decisions that Taxpayer cites, *McLeod* and *General Trading*, predate the 1987 decision in *Tyler Pipe*.

In 1998, the Arizona Court of Appeals dealt with a case that involved a use tax assessment against an Arizona purchaser of office furnishings. *O'Connor*, 192 Ariz. 200, 963 P.2d 279. The court examined whether the out-of-state manufacturer and seller, instead, was transaction privilege taxable. Noting that the U.S. Supreme Court has never held that the physical presence required for a seller's nexus must include both resident employees and permanent facilities, and citing *Quill* and *Tyler Pipe*, the Arizona Court of Appeals found substantial nexus with Arizona for purposes of the transaction privilege tax although the furniture manufacturer had no Arizona resident employees. *See O'Connor*, 192 Ariz. at 206-207, 963 P.2d at 285-286.

Furthermore, the Arizona Court of Appeals rejected the argument that a retail transaction privilege tax requires a higher level of nexus with the taxing state than does a use tax. *See Care Computer Systems*, 197 Ariz. at 416, 4 P.3d at 471. There, the taxpayer did not have property, inventory, a business address, resident employees, resident contractors, or

resident agents in Arizona. It had one salesperson assigned to Arizona who lived in California, did not initiate sales relationships in Arizona, and only took seven short trips to Arizona in a seven-year audit period. The court concluded that the former A.A.C. Rules 15-5-2306 through 15-5-2308, which Taxpayer cites, did not prevent the Department from assessing transaction privilege tax against a taxpayer that does not maintain a place of business within Arizona. *Id*., 197 Ariz. at 418-419, 4 P.3d at 473-474. The Assessment, therefore, does not constitute a new interpretation of the law under A.R.S. § 42-2078, and A.R.S. § 42-2078 did not prevent the Department from assessing transaction privilege tax against Taxpayer while the former administrative rules were in effect.

In its protest letters, Taxpayer attempts to distinguish its situation from that of the sellers in *O'Connor* and *Care Computer Systems*, arguing that its activities in Arizona were not significantly associated with establishing a market. Performing a contract, however, is maintaining a market. *See Interlott Technologies,* 205 Ariz. at 457, 72 P.3d at 1276. Taxpayer did maintain a market in Arizona by performing its contracts with Arizona customers and by sending its representatives to instruct customers and ensure their satisfaction with its products. Taxpayer's physical presence in Arizona exceeds that of the taxpayer in *Care Computer Systems* because unlike there, Taxpayer did have sales representatives located in Arizona.

Taxpayer has not provided any factual support for its statement before the formal hearing, that its customers resold Taxpayer's products. All gross proceeds of Taxpayer's sales are presumed to comprise the tax base for Taxpayer's retail business until the contrary is established. See A.R.S. § 42-5023.

The ALJ properly denied Taxpayer's protest.

ORDER

The ALJ's Decision is affirmed. .

This decision is the final order of the Department of Revenue. Taxpayers may contest the final order of the Department in one of two manners. Taxpayers may file an appeal to the

State Board of Tax Appeals, 100 North 15th Avenue, Suite 140, Phoenix, AZ 85007 or may bring an action in Tax Court (125 West Washington, Phoenix, Arizona 85003) within sixty (60) days of the receipt of this order. For appeal forms and other information from the Board of Tax Appeals, call (602) 364-1102. For information from the Tax Court, call (602) 506-3763.

Dated this 1st day of August 2011.

ARIZONA DEPARTMENT OF REVENUE

John A. Greene
Director

Certified original of the foregoing
mailed to:

[redacted]

Copy of the foregoing mailed to:

[redacted]

cc: Transaction Privilege and Use Tax Section
Office of Administrative Hearings
Transaction Privilege Tax Appeals