STATE OF ARIZONA

Department of Revenue

Douglas A. Ducey
Governor

David Briant
Director

PRIVATE TAXPAYER RULING LR16-012

December 5, 2016

Thank you for your letter dated June 22, 2016 requesting a private taxpayer ruling ("PTR") on behalf of your client, *** and its affiliates with locations in Arizona: *** (hereafter referred to collectively as "***" or "***"). Specifically, you requested a ruling regarding the applicability of the Arizona use tax to "***" utilized to facilitate *** ("***"), a component of *** platform. Pursuant to Arizona Revised Statutes (A.R.S.) § 42-2101, the Department may issue private taxpayer rulings to taxpayers and potential taxpayers on request.

ISSUE: Whether *** is responsible for the Arizona *use* tax in relation to fees it pays to third party *** developers to create '***' for use in its *** system?

RULING:
Based on the facts and documents provided, the Department rules as follows:
Because *** does not purchase the *** from the third party *** providers, *** *does not owe use tax on the ***.* Even though *** pays to have the *** created, the *** are created on the third party *** servers and ownership of the *** remains with the third party *** providers, so tangible personal property is not transferred, bartered or exchanged. After the development and creation of the ***, each third party *** provider must continue to maintain and support the *** located on its owns servers and infrastructure. In addition, if *** makes any changes to the ***, the third party *** providers must also make changes to their *** specific ***. Finally, in the event of termination of the *** Agreement, the third party *** provider must destroy or return to *** all confidential information and effect the termination of access to the *** by third party *** offices. As a result, there is no purchase of the *** by ***.

The Department *does not* make any determination regarding the taxability of the income derived by the third party *** providers from the *** they create for the *** system.

SUMMARY OF FACTS:

The following is a summary of the relevant facts based on your letter dated June 22, 2016, and subsequent correspondence with the Department on July 29, 2016, and October 10,

2016, together with copies of the typical *** Agreement ("*** Agreement"), *** Programmer Reference ("*** Programmer Manual") and the *** patent for the ***:

*** is headquartered in ***, ***. It provides ***, information and services to *** and *** providers. It internally developed the *** suite of software solutions internally for its own business purposes to handle its *** information management needs. The software is considered an *** ("***") and is used to ***.

*** also internally developed the *** System ("***") which is a patented,[1] web-based platform created as an off-shoot of the *** system. ***, like the *** system, provides for the electronic delivery and receipt of ***. It was developed for ** offices and *** that *do not* use ***'s system (i.e. they have their own *** systems which they purchased from other third-party vendors)[2] so that they may access *** from *** via the Internet.

Generally speaking, the *** system includes a central computer which is connected to client computers (e.g. computers at a ***'s office) via the internet. The central computer is also connected to *** and communicates individually with each of them. The client computer sends a request to the central computer which performs certain management functions.[3] The central computer then communicates with the ***. *** are sent to the central computer by the *** either manually or by instrument merge. When requested by the client computer, *** are transmitted over the internet by the central computer. Generally, the *** services are performed at ***'s central computers ("Hub") in ***, ***.

To facilitate interconnectivity and communication between the *** system and the various *** organizations' *** systems (i.e. the client computers), an *** must be configured to allow the two conflicting systems to accurately exchange data. Essentially, incoming and outgoing data (*** etc.) make an intermediate stop and pass through the *** for translation processing (to or from ***[4] machine readable format) prior to communicating with the *** (for incoming data) or the client computer (for outgoing data). The *** does not affect the

---

[1] United States Patent No. US ***

[2] *** is used by *** internally but has been sold separately for use as an *** system for *** offices and ***. Currently, there are only about a handful of ***'s offices that utilize ***'s *** system as their own *** system.

[3] E.g. it verifies the *** is eligible for *** payment, *** etc.

[4] *** (***) provides a framework (and related standards) for the exchange, integration, sharing, and retrieval of electronic *** information. These standards define how information is packaged and communicated from one party to another, setting the language, structure and data types required for seamless integration between systems. See http://www.***.org/implement/standards/ (last visited October 11, 2016).

communications between the *** and the central computer as they continue to communicate directly with the each other.

To initiate the creation of an ***, a ***'s office directs *** to the third party *** provider most knowledgeable with its specific *** system.[5] An agreement is signed (the "*** Agreement") between *** and the *** provider and *** provides each *** provider with a *** Programmer Manual which gives an overview of how the *** system works, the programming languages supported by *** and sample source codes that may be used to create the ***.

In creating the ***, the third party *** providers do not make any changes to the source code of ***'s software. Neither do they make any changes to the ***'s office software as the software is already in its completed form. Rather, the third party *** providers create new code and the *** that is created resides on the *** systems server on the *** provider's infrastructure or virtual server. Once created, *** does not have the ability to change the ***. After creation, the third party *** provider is also responsible for maintaining and supporting the *** as well as implementing updates or changes to the ***.[6]

*** tries to negotiate with the third party *** provider to create the *** for no fee. However, when a third party *** provider insists on charging a fee, *** pays the fee. Each provider invoices *** differently. Some providers bill *** an upfront fee with no yearly renewal charge, others may bill an upfront fee with a yearly renewal charge and still others may bill a "per click" charge or a fee based on the number of communications received and sent by *** to a ***'s office. All invoices are funded and paid by one master bank account owned by *** (the parent company).

The *** Agreement provides for an initial term of twenty-four months[7] with one year automatic renewals unless terminated by one of the parties. The *** Agreement also provides that the third party *** provider "retains all right, title and interest in and to the ***, software it solely develops."[8] If the *** Agreement is terminated, the agreement provides that the third party *** providers must destroy all confidential information it received from *** (e.g. the Programmer's source guide) and the *** providers must cooperate with *** to disallow its access to the ***. No source code is destroyed but access to the *** is disconnected (i.e. "turned off") by the *** provider.

---

[5] Most of the third party *** providers either sell/rent *** software systems to *** offices and *** or are specialty software development firms that deal in various ***/software technologies.
[6] See section 2.3 and 2.5 of the *** Agreement.
[7] Sixty months for "no-fee" arrangements. See Exhibit A to the *** Agreement.
[8] See section 2.12 of the *** Agreement.

DISCUSSION & LEGAL ANALYSIS:

Arizona's TPT differs from the sales tax imposed by most states. It is a tax on the privilege of conducting business in the State of Arizona. Specifically, the tax is measured by the amount or volume of business transacted by persons on account of their taxable business activities. See Arizona Revised Statutes (A.R.S.) §42-5008(A). Thus, it differs from a true sales tax in that the TPT is levied on income derived by the seller. The seller may legally pass the economic expense of the tax on to the purchaser, however, the seller is ultimately liable for the tax.

The Arizona use tax is a complementary tax to the TPT. If a company does not have an Arizona business presence or nexus for TPT purposes, Arizona's use tax applies. The use tax applies to *purchases* of tangible personal property from an out-of-state retailer or utility business that are *used or consumed* in Arizona. See A.R.S. § 42 5155(A). The consumer is liable for the use tax.

For use tax purposes, a "purchase" is defined as "any transfer, exchange or barter, conditional or otherwise, in any manner or by any means, of tangible personal property for a consideration, including transactions by which the possession of property is transferred but the seller retains the title as security for payment." A.R.S. § 42-5151(13). "Use or consumption" is very broadly defined in the Arizona statutes as "the exercise of any right or power over tangible personal property incidental to owning the property except holding for sale or selling the property in the regular course of business." A.R.S. § 42-5151(22). A "retailer" is defined as "every person engaged in the business of making sales of tangible personal property for storage, use or other consumption…" See A.R.S. § 42-5151(17)(a). A.R.S. § 42-5001(17) defines "tangible personal property" as "personal property which may be seen, weighed, measured, felt or touched or is in any other manner perceptible to the senses."

Consistent with the broad definition of tangible personal property as provided in A.R.S. § 42 5001(17), there is longstanding precedent in case law for that definition to be applied to subjects other than physical goods, such as electricity, electronic delivery of software, and music played from a jukebox. Significantly, in applying the broad definition of tangible personal property, numerous courts have concluded that software is tangible personal

property and subject to tax.[9] In *Wal–Mart Stores, Inc. v. City of Mobile*,[10] for example, the court held software was tangible personal property because the physical copy of the code was on some tangible medium.[11]

In this case, the *** is created using code which is considered software and so tangible personal property is implicated. Assuming the third party *** providers are "retailers" for Arizona use tax purposes,[12] it must be determined whether *** *purchased* this tangible personal property (i.e. the software) from those retailers and used or consumed that property in Arizona.

For use tax purposes, a "purchase" is defined as "any transfer, exchange or barter, conditional or otherwise, in any manner or by any means, of tangible personal property for a consideration.[13] The Arizona statutes do not define the terms transfer, barter or exchange. When the legislature has not defined terms and it does not appear from the context that a special meaning was intended, the ordinary meaning of the words must be consulted. *State Board of Dispensing Opticians v. Schwab*, 93 Ariz. 328, 380 P.2d 784 (1963); *Arizona State Tax Commission v. First Bank Building Corp.,* 5 Ariz. App. 594, 429 P.2d 481 (1967); *State Tax Commission v. Peck*, 476 P.2d 849, 850–51, 106 Ariz. 394, 395–96 (Ariz. 1970)

The online Merriam-Webster.com dictionary defines "transfer"[14] as i) to convey from one person, place, or situation to another, move, shift; ii) to cause to pass from one to another, transmit; iii) transform, change. It defines "barter"[15] as to "exchange things (such as products or services) for other things instead of for money." Finally, it defines an

---

[9] See, e.g., *Comshare, Inc. v. United States*, 27 F.3d 1142 (6th Cir.1994) (income tax credit); *Wal–Mart Stores, Inc. v. City of Mobile*, 696 So.2d 290 (Ala.1996) (sales tax); *Andrew Jergens Co. v. Wilkins*, 109 Ohio St.3d 396, 848 N.E.2d 499 (2006) (property tax).

[10] 696 So.2d 290 (Ala.1996).

[11] *Walmart,* 696 So. 2d at 291, citing *South Cent. Bell Tel. Co. v. Barthelemy*, 643 So.2d 1240, 1244–45 (La.1994).

[12] *** indicates that it deals with thousands of ***'s offices from across the country each of which could have a different *** system. Thus, numerous *** providers, each of which may have a different business model may be implicated. The Department does not make a ruling as to whether each of the third party *** providers that *** deals with is in fact a "retailer" as defined by Arizona statutes.

[13] A.R.S. § 42-5151(13).

[14] "Transfer." Merriam-Webster.com. Merriam-Webster, n.d. Web. 11 Oct. 2016.

[15] "Barter." Merriam-Webster.com. Merriam-Webster, n.d. Web. 11 Oct. 2016.

"exchange"[16] as i) an occurrence in which people give things of similar value to each other; ii) the act of giving or taking one thing in return for another thing.

When the *** is created, it is hosted and remains on the *** provider's servers and infrastructure for the duration of the *** Agreement. After the development and creation of the ***, each third party *** provider must continue to maintain and support the ***. In addition, if *** makes any changes to its *** system, the third party *** providers must also make changes to their ***. This responsibility continues theoretically until the *** Agreement is terminated at which point any confidential material in the hands of the *** provider must be destroyed and access to the *** is disconnected so that neither *** nor the *** office is able use the *** to communicate. However, the *** code (i.e. the software) is not destroyed, rather, it remains on the *** provider's servers. This, in addition to the fact that the *** Agreement specifically provides that *** provider "retains all right, title and interest in and to the ***, software it solely develops" and the fact that it provides for continuous successive renewals is indicative that the *** created by *** provider was not "purchased" by *** as that term is defined in the Arizona use tax statutes; there was no transfer, exchange or barter. As a result there was no purchase of tangible personal property and thus *** is not responsible for the use tax on its transactions with the third party *** providers.

Additionally, because the Department finds there was no purchase it does not make a determination as to whether tangible personal property is used or consumed in Arizona under A.R.S. § 42 5155(A).

The Department *does not* make any determination regarding the taxability of the income derived by the third party *** providers from the *** they create for the *** system.

This response is a private taxpayer ruling and the determinations herein are based solely on the facts provided in your request. Therefore, the conclusions in this private taxpayer ruling do not extend beyond the facts presented in your correspondence. The determinations are subject to change should the facts prove to be different on audit. If it is determined that undisclosed facts were substantial or material to the department's making of an accurate determination, this private taxpayer ruling shall be null and void. Further, the determination is subject to future change depending on changes in statutes, administrative rules, case law or notification of a different department position.

---

[16] "Exchange." Merriam-Webster.com. Merriam-Webster, n.d. Web. 11 Oct. 2016.

The determinations in this private taxpayer ruling are only applicable to the taxpayer requesting the ruling and may not be relied upon, cited nor introduced into evidence in any proceeding by a taxpayer other than the taxpayer who has received the private taxpayer ruling. In addition, this private taxpayer ruling only applies to transactions that occur or tax liabilities that accrue from and after the date the taxpayer receives the ruling.