PRIVATE TAXPAYER RULING LR02-020

November 5, 2002

The following private taxpayer ruling is in response to your letter dated July 19, 2002. You have requested a ruling on behalf of … ("Taxpayer") regarding the transaction privilege tax implications associated with future payments pursuant to current and future computer software licensing and computer data processing service agreements.

Statement of Facts:

The following is a restatement of the facts as presented in your request.

Taxpayer is an electronic solution services provider located in …, Arizona. Taxpayer's business activities include developing and licensing application software and providing data processing services to store, process and manipulate customer-supplied data using its application software. The application software developed by taxpayer is used to sort numbers of sales of individual retail items into categories. Depending on the clients' needs the data is then processed into electronic reports based on selected price models.

Under a software license agreement ("License Agreement"), Taxpayer has entered into a contractual relationship to license its software for use by a third party ("Licensee") whose home office is located in the State of Wisconsin. This License Agreement provides for Licensee to pay consideration for the right of the use of Taxpayer's software while Taxpayer retains all ownership interests therein. Furthermore, Licensee's permitted uses of the software are also limited. Specifically, Licensee may not make the software available to third parties by duplication, renting, marketing, distributing or for processing third party data. The Licensee also may not attempt in any way to discover the source code of the software.

Pursuant to the License Agreement, Licensee may choose to operate the software itself, contract with an agreed-upon third party to operate the software, or contract with Taxpayer for the operation of the software. As indicated by the service agreement ("Service Agreement"), Licensee has selected Taxpayer to provide data processing services in conjunction with the license and operation of the software. The Service Agreement provides for Taxpayer to operate the software in-house and provide application processing, product support, hardware environment and model evaluation services. By purchasing Taxpayer's services, Licensee does not acquire any ownership in or any control over the hardware environment set up by Taxpayer in performance of those services. As a result of the Service Agreement, Taxpayer hosts the operation of the software and there is no physical transfer of the software or of any

tangible personal property to Licensee. Furthermore, there is no requirement within the License Agreement or the Service Agreement that an exchange of software take place through physical media.

Taxpayer has recently received approximately one half of the license fees associated with the License Agreement in the amount of $1,500,000 and will receive the remaining balance of $1,550,000 in February 2003. Taxpayer has not received any payment for fees associated with the Service Agreement. Future licensing and service agreements will be structured in the same manner as the License and Service Agreements described herein. Taxpayer is requesting a ruling with regard to the future payment of license fees and service fees as a result of the License and Service Agreements; and future license and service agreements similarly structured and entered into by Taxpayer.

Issue:

Whether the Taxpayer's licensing of the software constitutes the sale of tangible personal property or the sale of a service.

Your Position:

It is your position that the License Agreement in conjunction with the Service Agreement constitutes non-taxable services. Such transactions and any similar future transactions do not constitute a sale of tangible personal property or the rental of tangible personal property, and therefore are not subject to Arizona transaction privilege tax.

Applicable Law:

Arizona Revised Statutes ("A.R.S.") § 42-5001(13) defines sale as "any transfer of title or possession, or both, exchange, barter, lease or rental, conditional or otherwise, in any manner or by any means whatever, including consignment transactions and auctions, of tangible personal property or other activities taxable under this chapter, for a consideration."

A.R.S. § 42-5001(16) 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.

A.R.S. § 42-5061 imposes the transaction privilege tax on the business of selling tangible

personal property at retail.

A.R.S. § 42-5061(A)(1) provides an exemption from transaction privilege tax for the gross proceeds of sales of the gross income from professional or personal service occupations or businesses.

A.R.S. § 42-5061(A)(2) excludes services rendered in addition to selling tangible personal property at retail from tax under the retail classification.

A.R.S. § 42-5071 imposes the transaction privilege tax on the business of leasing or renting personal tangible property.

Arizona Administrative Code ("A.A.C.") R15-5-154 sets forth the taxability of data processing services and equipment.

Discussion:

Arizona's transaction privilege tax is a tax on the privilege of conducting business in the State of Arizona. The seller may pass the burden of the tax on to the purchaser; however, the seller is ultimately liable to Arizona for the tax. The transaction privilege tax is imposed on the business of selling tangible personal property at retail in accordance with A.R.S. § 42-5061. The tax base is the gross proceeds of sales or gross income derived from the business. All sales of tangible personal property are subject to tax unless specifically exempt by statute.

Taxpayer's software constitutes tangible personal property

Whether the sale of computer software is subject to transaction privilege tax is dependent upon the nature of the software. First it must be determined whether the software constitutes pre-written software ("canned software") or custom software.

The sale of canned software is a sale of tangible personal property subject to tax under the retail classification. Canned software is software designed and manufactured for retail sale and not under the specifications or demands of any individual client. It includes software that may have originally been designed for one specific customer but which becomes available for sale to others. The creation of a generally marketable software program, which will be used by no one particular customer, is not a service.

The provision of a canned computer program, whether or not characterized as a license agreement, is a taxable retail sale. While it is not clear whether leases or rentals of canned software exist, if leases or rentals of canned computer software do exist, the proceeds from the

leases or rentals are taxable under the personal property rental classification.

When canned software is installed, modifications may be made such as supplying requisite parameters and data for the program to perform on certain hardware. The modification of canned computer software at installation does not transform the canned software into custom software. Although the sale of the canned software is taxable, the charges for installation are exempt from tax provided the charges for the service are separately stated on the invoice and in the books and records.

In contrast to canned computer software, custom software is software designed exclusively to the specifications of one customer's unique application. The service in this case is the dominant element and involves assessing needs, preparing specifications and developing and writing a program for a specific customer. The sale of such software is the sale of a professional service and not subject to tax.

In the case at hand, Taxpayer is licensing the use of its Product and Updates ("Product"). The Product is the computer software program(s) owned or distributed by Taxpayer. Updates are updated or revised versions of the Product which encompass logical improvements, extensions, and other changes. Taxpayer retains all right, title, and interest in the Product. The program being licensed under this particular License Agreement is the …. … is an application that helps retailers to price their products in order to accomplish their sales goals. … consists of three modules called …, …, and …. It appears that no modifications are made to the basics of the program structure; however, once installed, the Licensee's data is added to process electronic reports, which are distributed to the Licensee. The mere addition of data does not constitute customization. Therefore, the Product licensed to Licensee constitutes a retail sale of canned software and is subject to transaction privilege tax, unless otherwise exempt.

Licensing of computer software constitutes a sale of tangible personal property

Arizona transaction privilege tax statutes do not specifically address the licensing of tangible personal property. "Sale" is defined in A.R.S. § 42-5001(13) as "any transfer of title or possession, or both, exchange, barter, lease or rental, conditional or otherwise, in any manner or by any means whatever, including consignment transactions and auctions, of tangible personal property or other activities taxable under this chapter, for a consideration…." The broad definition of "sale" encompasses the gross receipts derived from sales of canned software as well as licensing agreements that provide for the continued use of the canned software program. See A.A.C. R15-5-154(c); Arizona Transaction Privilege Tax Ruling TPR 93-48.

Even so, Taxpayer submits that because there has been no transfer of physical media, the transaction does not constitute a sale under the retail classification. The department disagrees. The form of delivery is not relevant. The sale of computer software is a sale of tangible

personal property, regardless of the method of transmittal, and is subject to transaction privilege tax unless a specific statutory exemption applies. As a result, the licensing of the Product without a transfer of software via physical media to a consumer is subject to tax as a sale of tangible personal property at retail unless a specific exemption applies.

Services rendered in addition to a retail sale are not subject to transaction privilege tax

Pursuant to A.R.S. § 42-5061(A)(2) gross proceeds from services rendered in addition to selling tangible personal property at retail are not subject to tax. In addition, professional and technological computer services are non-taxable professional services.

Pursuant to A.A.C. R15-5-154,

> Income from the multiple use of data processing equipment where no single customer has exclusive use of the equipment for a fixed period of time, or where the customer does not exclusively control all manual operations necessary to operate the equipment is nontaxable service income.

When income is received from both the sale of tangible personal property and exempt services, the charges must be separately stated on the invoice and clearly reflected in the books and records. If the charge for exempt service is not separately stated from the sale of tangible personal property, the gross income from the transaction is taxable. A.A.C. R15-5-105.

Based on the information provided in the request the services provided by Taxpayer include the operation of the software, application processing, product support, hardware environment, model evaluation, and consulting services. According to the Service Agreement details provided in Exhibit A, Exhibit B, Exhibit C, Exhibit D, and Exhibit E of the request for a private taxpayer ruling, the fees associated with these services are charged separately. Therefore, the computer services provided in addition to the license of canned software are not subject to tax as long as they are separately stated on the invoice and separately accounted for in the books and records. However, additional charges for software updates and software modifications are subject to tax. If the taxable charges are not shown separately from the nontaxable charges the total amount is subject to tax.

Conclusion and Ruling:

The following ruling is given based on the facts presented in your request. The department rules that the gross proceeds from payments received pursuant to Taxpayer's licensing of computer software is taxable as well as any additional charges for Updates and modifications.

On the other hand, services provided under the Service Agreement are not subject to transaction privilege tax as long as they are separately stated.

The conclusions in this private taxpayer ruling do not extend beyond the facts presented in your letter dated July 19, 2002, as well as the additional information provided on September 10, 2002, and September 18, 2002.

This response is a private taxpayer ruling and the determinations herein are based solely on the facts provided in your request. 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 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.

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.