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PRIVATE TAXPAYER RULING LR06-004

June 28, 2006

The Department issues this private taxpayer ruling in response to your letter of September 21, 2005, in which you request a ruling on behalf of your company . . . ("Company") . . . on the applicability of Arizona transaction privilege tax to certain revenue attained from Company's business activities in developing, manufacturing, and selling various computer hardware, software, and related components. You provided supplemental information requested by the Department on November 16, 2005.

Statement of Facts:

The following facts are excerpted from your November 16 letter:

[Programmable logic devices (PLDs)] are semiconductor chips that can be customized and programmed by the customer using software tools that run on personal computers or engineering workstations. [Company] develops, manufactures, and sells high-density, microchips, PLDs, related hardware, software and intellectual property cores for use in designing the PLDs. . . . [Company]'s primary customers are distributors. [Company] anticipates future increases in direct sales to manufacturers of consumer electronics and communications devices.

. . . .

[Company] and customer enter into a contract for [Company] to develop a previously un-marketed structured-application-specific-integrated-circuit (ASIC) microchip utilizing customer supplied files on [a Company] base array. [Company] refers to the processes outlined in this request collectively as [Process]. The new device is a combination of the customer's data files (microcircuits) and [Company] data files (microcircuits). Customers utilize [Company] software tools to design their microcircuits in a computer environment. Customers have the option of incorporating pre-designed "modules" contained in the software tools in their chip design at no additional charge. The pre-designed modules contain microchip circuitry used to perform common routines such as clock or calculation functions. Software tools are delivered via electronic transmission and may require the use of a dongle or hard token. Dongles or hard tokens are included in the selling price of the software tools when required for tools operation.

Dongles and hard tokens . . . must be physically attached in or onto a computer to permit the use of the desired software program. The dongle or hard tokens are for security purposes and are intended to eliminate the use of unauthorized software copies.

PRIVATE TAXPAYER RULING LR06-004

June 28, 2006

Page 2

[Company] provides one time non-recurring engineering services (NRE) to merge/graft the customer's electronic design files with the existing [Company] base array files in a computer environment. Successful technology pairings are migrated to a standard [Company] base array (microchip). A successful project will result in a newly created process as evidenced by a device that is distinctive in nature. The final ASIC device will have unique functions, highly specialized performance characteristics, and satisfy a previously unfilled customer need. . . .

Upon satisfactory development, fabrication, and testing[,] the customer is provided functional prototypes for evaluation and confirmation of successful design. The prototypes are not intended for functional use or resale. The customer uses the prototypes solely to test and evaluate the design characteristics. Customers communicate approval/acceptance of design concept using the [Process] Prototype acceptance form.

In general, customers have six . . . months from concept approval date to take delivery of an agreed upon minimum order quantity (MOQ). Subsequent production purchases of approved designs are generally under a separate purchase order. Customers may cancel or reschedule a production order with proper notice. Penalties are charged for untimely cancellations of the NRE contract for cost recovery based on agreed upon terms in the contract. [Company]'s design, development, and production of [Process] devices is not contractually deemed a "work for hire". [Company] does not assign or transfer any intellectual property rights to the customer, other than the right to use the [Process] devices in customer's target systems.

. . . Substantially all of the activities performed in the design processes will involve some degree of uncertainty. Intensive and specialized testing is required at each phase of development.

Your Issues:

Based on the arguments presented in your request, you raise the following issues:

1. Are charges for [Process] services to design a new ASIC device subject to transaction privilege or use tax?
2. Are the initial prototypes given at no charge subject to transaction privilege or use tax? If so, what is the measure of tax?
3. Are subsequent sales of prototypes subject to transaction privilege or use tax?
 - a. If additional prototypes sold are to be used for further testing and evaluation?
 - b. If additional prototypes are to be consumed by the customer?
 - c. If additional prototypes are to be resold by the customer?

PRIVATE TAXPAYER RULING LR06-004

June 28, 2006

Page 3

4. Are charges for software tools used by customers to design their microcircuitry in a Company preferred format subject to transaction privilege or use tax:
 - a. If delivered in a physical form (e.g., compact disc or disk)?
 - b. If delivered electronically via email or download?
 - c. If delivered intangibly with a tangible dongle or hard token?
5. Are production units sold under the minimum order quantity requirement subject to transaction privilege or use tax?
6. Are cancellation charges associated with early termination of an NRE contract subject to transaction privilege or use tax? If so, what is the measure of tax?
7. Are cancellation charges associated with early termination of the minimum order quantity requirements for production units subject to transaction privilege or use tax? If so, what is the measure of tax?
8. Is the use of the intellectual property cores (i.e., prewritten sub-routines/circuitry contained in the software tools) incorporated by customers into the new ASIC microchip subject to tax if a fee is charged?

Your Positions:

You did not present specific conclusions in your request.

Conclusion and Ruling:

Arizona transaction privilege tax is a tax on the privilege of conducting business in the state, and is measured by the *gross receipts* of the taxpayer. See A.R.S. § 42-5008(A); *DaimlerChrysler Servs. N. Am., L.L.C. v. Ariz. Dept't of Revenue*, 110 P.3d 1031, 1036 (Ariz. Ct. App. 2005) (citing *Arizona Tax Commission v. Southwest Kenworth*, 561 P.2d 757, 760 (Ariz. Ct. App. 1977)). Gross receipts broadly include, among other things, the value proceeding or accruing from the sale of tangible personal property, without any deduction on account of the cost of property sold, materials used, labor or service performed, interest paid, expense of any kind or losses. See A.R.S. § 42-5001(7). Consequently, a taxpayer's various costs incurred in such areas are generally subject to tax unless otherwise exempted by statute.

Under the retail classification, which imposes transaction privilege tax on the business of selling tangible personal property at retail, A.R.S. § 42-5061(A)(1) exempts the gross proceeds of sales or gross income derived from “[p]rofessional or personal service occupations or businesses which involve sales or transfers of tangible personal property only as inconsequential elements.” A.R.S. § 42-5061(A)(2) exempts the gross proceeds of sales or gross income derived from “[s]ervices rendered in addition to selling tangible personal property at retail.” Also, as described in Arizona Administrative Code (“A.A.C.”) R15-5-122, “[s]ales of articles to be incorporated into a fabricated or manufactured product

PRIVATE TAXPAYER RULING LR06-004

June 28, 2006

Page 4

are considered to be sales for resale and, therefore, exempt.” The rule conditions application of this exemption to materials that “actually become a part of the finished product,” as opposed to supplies that are “consumed in the manufacturing process.”

Arizona use tax is a complementary tax to the transaction privilege tax that generally applies to the use, storage, or consumption in this state of tangible personal property purchased from an out-of-state retailer or utility business. See A.R.S. § 42-5155. The consumer is liable for the use tax; but a vendor may be responsible for collecting and remitting the tax to the state when nexus is established or if the vendor otherwise assumes such collection and remission responsibilities. The use tax is also imposed on anyone who purchases tangible personal property for resale but subsequently uses or consumes the property. There is no county use tax.

Use tax is levied as a percentage of the “sales” or “purchase” price, which A.R.S. § 42-5151(14) defines to broadly include, among other things, “the total amount for which tangible personal property is sold, including any services that are a part of the sale, valued in money, whether paid in money or otherwise, and any amount for which credit is given to the purchaser by the seller without any deduction on account of the cost of the property sold, materials used, labor or services performed, interest charged, losses or other expenses.”

Similar to the exemption described in A.A.C. R15-5-122, A.R.S. § 42-5159(A)(4) provides a use tax exemption for “[t]angible personal property which directly enters into and becomes an ingredient or component part of any manufactured, fabricated or processed article, substance or commodity for sale in the regular course of business.”

A.R.S. § 42-5061(A)(1) exemption

The Department has explained that professional and personal service occupations “are those wherein the professional is able to engage in the occupation by virtue of a state sanctioned or state issued license to engage in that occupation” (e.g., lawyers, doctors, cosmeticians, etc.), whereas examples of “service businesses,” which are also covered by the exemption, include “vehicle maintenance garages, pest control, lawn maintenance and other like services.” See *Arizona Transaction Privilege Tax Ruling* TPR 90-2 (Aug. 1, 1990). In the context of a professional or personal service occupation or service business, “the services are geared toward the particular needs of the customer with the final product/service meeting those specific needs” wherein the final product need not be in tangible form, and the exemption generally covers those inconsequential sales or transfers of tangible personal property that are utilized by the person engaged in the occupation or business in the actual operation thereof or to facilitate the service (e.g., shampoo used by a hair stylist to wash a customer's hair). *Id.* Under A.A.C. R15-5-104(C),

Sales of tangible personal property shall be considered inconsequential elements of the service if:

PRIVATE TAXPAYER RULING LR06-004

June 28, 2006

Page 5

1. The purchase price of the tangible personal property to the person rendering the services represents less than 15% of the charge, billing, or statement rendered to the purchaser in connection with the transaction;
2. At the time of the sale, the tangible personal property transferred is not in a form which is subject to retail sale; and
3. The charge for the tangible personal property is not separately stated on the invoice.

Assuming they meet the A.A.C. R15-5-104(C) “inconsequentiality test,” such sales and transfers of tangible personal property are exempt from transaction privilege tax under A.R.S. § 42-5061(A)(1). In contrast, sales or transfers of tangible personal property that fall outside the scope of the exemption include sales of items that are not tailored specifically to a particular customer and are otherwise normally available from a merchant in a retail transaction (e.g., hair salon's sale to a customer of a bottle of shampoo). See *id.* Such transactions would be subject to transaction privilege tax, unless another exemption applies.

A.R.S. § 42-5061(A)(2) exemption

In *Arizona Transaction Privilege Tax Ruling* TPR 93-31 (May 10, 1993), the Department explained that the A.R.S. § 42-5061(A)(2) exemption generally applies to gross income derived from service activities rendered in addition to retail sales that fall into one (or more) of three categories: (1) repair labor, (2) installation labor that is not otherwise taxable under the A.R.S. § 42-5075 prime contracting classification, and (3) instruction and training. Nevertheless, TPR 93-31 explained that the three categories “are not intended to be an exclusive listing.” Consequently, the A.R.S. § 42-5061(A)(2) exemption could cover other services that are rendered in addition to a retail sale *if*, like the three categories of services described, the services are performed separate from—and thus “in addition to”—the sale of tangible personal property.

In this analysis, if a retailer-taxpayer creates tangible personal property that it subsequently sells at retail, activities that fall within the scope of the A.R.S. § 42-5061(A)(2) exemption must be distinct from those involved in the actual creation of the tangible personal property at issue. The principle is that, to constitute exempt gross receipts derived from a service “in addition to” the sale, such exempt receipts cannot include taxable gross receipts derived from the vendor's costs of selling at retail, which, in the instance of a vendor that creates the property it subsequently sells, would include costs it passes on to the consumer for creating or fabricating the product. See A.A.C. R15-5-126; *Walden Books Co. v. Ariz. Dep't of Revenue*, 12 P.3d 809, 812 (Ariz. Ct. App. 2000); *City of Phoenix v. Ariz. Rent-a-Car Sys., Inc.*, 893 P.2d 75, 79 (if activities of the taxpayer are incidental such that they are inseparable from the principal business and interwoven with the operation thereof to the extent that they are in effect an essential part of the major business, they will not be treated

PRIVATE TAXPAYER RULING LR06-004

June 28, 2006

Page 6

as a separate business for taxation purposes). See also *Walden Books*, 12 P.3d at 812 (income from services that are part of retail sales are included in the retail classification tax base because they are not services rendered in addition to selling tangible personal property at retail).

Sales of "Canned" or Prewritten Software

Arizona Transaction Privilege Tax Ruling TPR 93-48, available online at www.azdor.gov/ResearchStats/rulings/tpr93-48.htm, addresses the taxation of computer hardware, software, and related services. As TPR 93-48 explains, the sale of prewritten or "canned" computer software is considered to be a sale of tangible personal property subject to tax under the retail classification. Prewritten 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 that becomes available for sale to others.

As addressed in A.A.C. R15-5-154(B), generally, "gross receipts derived from the sale of computer software programs are taxable, regardless of the method that a retail business uses to transfer the programs to its customers." A.A.C. R15-5-154(C) lists two forms of nontaxable service activities relating to computer software:

1. The original creation of an electronic data processing program for the specific use of an individual customer.
2. The modification of a prewritten computer software program for the specific use of an individual customer, if the charge for the modification is shown separately on the sales invoice and records.

Based on the facts provided by Company and the discussion above, the Department rules as follows:

1. Pursuant to A.R.S. § 42-5061(A)(1), Company's gross receipts derived from charges for [Process] services to design a new ASIC device are exempt from Arizona transaction privilege tax and use tax if Company's sales of the initial prototypes meet the A.A.C. R15-5-104(C) inconsequentiality test, as applied in Part 2 of this ruling *infra*. If the sales do not meet the inconsequentiality test, gross income derived from charges for [Process] services are merely Company's labor, services, and expenses incurred in the course of selling tangible personal property at retail and subject to transaction privilege tax under the retail classification, provided that Company has sufficient nexus with Arizona. If Company lacks sufficient nexus for taxation purposes, Company's Arizona customer is subject to Arizona use tax on the charges for [Process] services, which would constitute a part of the purchase price of an ASIC device.

PRIVATE TAXPAYER RULING LR06-004

June 28, 2006

Page 7

2. Company's provision of initial prototypes to its customers are considered inconsequential elements of a nontaxable service if, pursuant to the "inconsequentiality test" in A.A.C. R15-5-104(C), Company meets each of the following three elements:
 - a. Company's purchase price of the components for fabricating the prototypes represents less than 15 percent of the charge, billing, or statement rendered to the purchaser in connection with the transaction.
 - b. At the time of the sale, the initial prototypes are not transferred in a form that is subject to retail sale.
 - c. The charge for the initial prototypes is not separately stated on the invoice.

If Company's sales of the prototypes do not meet the inconsequentiality test, the gross receipts derived from the sales are subject to transaction privilege tax under the retail classification, as there is no general transaction privilege tax exemption for sales of "prototypes." If Company lacks sufficient nexus for taxation purposes, Company's Arizona customer is subject to Arizona use tax on the purchase price of the prototypes.

3. Except as provided in Subsection 3(c) below, Company's gross receipts derived from sales of [Process] devices to an Arizona customer, subsequent to the customer's approval of the initial prototype, are subject to Arizona transaction privilege tax under the retail classification, provided that Company has sufficient nexus with Arizona. If Company lacks sufficient nexus for taxation purposes, Company's Arizona customer is subject to Arizona use tax on the purchase price of the devices.
 - a. Company's gross receipts derived from [Process] devices sold for use by the Arizona customer in further testing and evaluation are subject to Arizona transaction privilege tax under the retail classification. If Company lacks sufficient nexus for taxation purposes, Company's Arizona customer is subject to Arizona use tax on the purchase price of the devices.
 - b. Company's gross receipts derived from [Process] devices to be used or consumed by an Arizona customer are subject to Arizona transaction privilege tax under the retail classification. If Company lacks sufficient nexus for taxation purposes, Company's Arizona customer is subject to Arizona use tax on the purchase price of the devices.
 - c. Company's gross receipts derived from [Process] devices to be resold by an Arizona customer are exempt from transaction privilege tax as a sale for resale, provided that the customer presents Company with a valid Arizona exemption certificate.

PRIVATE TAXPAYER RULING LR06-004

June 28, 2006

Page 8

4. Company's gross receipts derived from sales of software tools, which constitute unmodified prewritten software as described, are subject to Arizona transaction privilege tax under the retail classification, regardless of the means of delivery (e.g., whether delivered on a physical medium or electronically), provided that Company has sufficient nexus with Arizona. If Company does not have sufficient nexus for taxation purposes, Company's Arizona customer is subject to Arizona use tax on the purchase price of the software.
5. Company's gross receipts derived from sales of production units sold under the minimum order quantity requirement are subject to Arizona transaction privilege tax under the retail classification, provided that Company has sufficient nexus with Arizona. If Company does not have sufficient nexus for taxation purposes, Company's Arizona customer is subject to Arizona use tax on the purchase price of the units.
6. If Company's NRE services are exempt under A.R.S. § 42-5061(A)(2), in that they are distinct from the various manufacturing and fabrication activities conducted by Company as part of its business of selling tangible personal property at retail, Company's gross receipts derived from cancellation charges associated with early termination of an NRE contract are exempt from Arizona transaction privilege tax. If Company's gross income derived from NRE services are part of the taxable gross receipts it derives from its retail business, however, the gross receipts derived from cancellation charges are subject to transaction privilege tax, provided that Company has sufficient nexus with Arizona. If Company does not have sufficient nexus for taxation purposes, Company's Arizona customer is subject to Arizona use tax on such charges as part of the purchase price of the units ordered.
7. Company's gross receipts derived from cancellation charges associated with early termination of the minimum order quantity requirements for production units are subject to transaction privilege tax, provided that Company has sufficient nexus with Arizona. If Company does not have sufficient nexus for taxation purposes, Company's Arizona customer is subject to Arizona use tax on such charges as part of the purchase price of the units ordered.
8. Company's gross receipts derived from fees charged for the use of "intellectual property cores" are subject to transaction privilege tax under the retail classification as sales of prewritten software, provided that Company has sufficient nexus with Arizona. If Company does not have sufficient nexus for taxation purposes, Company's Arizona customer is subject to Arizona use tax on the purchase of prewritten software.

If any of the transactions mentioned above involves sales of microchips that are incorporated by an Arizona customer into a fabricated or manufactured product subsequently offered for retail sale, the gross receipts derived from or purchase of the

PRIVATE TAXPAYER RULING LR06-004

June 28, 2006

Page 9

microchips are exempt from transaction privilege or use tax. To provide proof of this incorporation, the Department recommends that Company obtain a valid Arizona exemption certificate from the customer. For example, if an Arizona customer presents Company with a valid Arizona exemption certificate because it incorporates the microchips it purchases from Company into calculators that it subsequently offers for retail sale, Company's gross receipts derived from the sale are exempt from transaction privilege tax and the customer is not subject to use tax on the purchase.

This office does not make nexus determinations. As provided in *Arizona General Tax Procedure* GTP 01-3 (available online at www.azdor.gov/ResearchStats/proc/gtp01-03.htm), the Department generally declines to issue private taxpayer rulings on questions involving fact-intensive issues, "such as whether a unitary business exists, whether a taxable nexus exists or the value of property on a certain date." Please direct any questions regarding Company's nexus to the Department's Nexus Section:

Arizona Department of Revenue
Transaction Privilege and Use Tax
Nexus Section
P.O. Box 29062
Phoenix, AZ 85038-9062
(602) 716-6533

This private taxpayer ruling does not extend beyond the facts presented in your letters of September 21 and November 16, 2005.

This response is a private taxpayer ruling and the determination herein is 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.