STATE OF ARIZONA
Department of Revenue

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Governor

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Director

PRIVATE TAXPAYER RULING LR07-004

May 7, 2007

This private taxpayer ruling is in response to your letter dated February 16, 2006, in which you requested a private taxpayer ruling on behalf of … ("Taxpayer"). You request a ruling concerning whether each of Taxpayer's three … charges are exempt from Arizona transaction privilege tax ("TPT"), under Arizona Revised Statutes ("A.R.S.") § 42-5064(A). Pursuant to A.R.S. § 42-2101, the Department may issue private taxpayer rulings to taxpayers and potential taxpayers on request.

Statement of Facts:

Your February 16, 2006 letter presents the facts relating to Taxpayer's business as follows:

Taxpayer is a financial technology service provider to the global investment community. Taxpayer offers numerous products and services to its clients. The majority of Taxpayer's revenue is comprised of sales of software and charges for utilization of the Taxpayer's … Network ("…"). Taxpayer's software development and … service are separate and distinct lines of business. The … activity is the subject of the letter ruling request.

… is a secure, reliable connection between asset managers (buy-side client) and investment brokers (sell-side client). The service provides a specific technology-based platform so that the buy-side and sell-side of the trading community may communicate with one another on the … ("…") protocol. The … Protocol is a series of messaging specifications developed through the collaboration of members of the financial services industry. … is not software. Rather, it is a specification around which software developers can create commercial or open-source software. Taxpayer is one of these software developers.

Access to the … provides Taxpayer's clients with real-time data, trading, and post-trading solutions offered by other … members. Taxpayer does not provide any trading information or data to its clients. Instead, access to the … provides an end-to-end solution guaranteeing message trafficking (i.e., a connection) via technological support (i.e., software integration and troubleshooting).

The … is subdivided into three separate categories for which on-going revenue is received through a single monthly charge. The charge consists of the following three

revenue pieces: (1) … Network Access, (2) … Connection, and (3) … Support. A brief description of each is listed below.

(1) *… Network Access:* In order to eliminate quality control issues, Taxpayer does not allow its customers to lease or purchase their own telecommunications equipment or services which support the … Protocol. Therefore, Taxpayer incurs charges from various telecommunications providers in the provision of its … Connection services. These charges are for the physical connections that are required to support the network access and include lease charges for routers, circuits and, in certain instances, … lines. Taxpayer then passes these costs on to its clients via an "… Network Access" charge. Taxpayer deems itself the end-user of these telecommunications services and pays the tax imposed.

(2) *… Connection:* The … Connection represents a guarantee of interoperability between …'s member clients. These connections are not the physical connections (described above as "… Network Access") but rather a service provided by Taxpayer to ensure that the software used by two clients or members of the … network are compatible and secure. Each … Connection charge includes testing and re-testing of the client's systems and production support should any problems occur during production usage. Additionally, each charge is on a "per pair" basis (i.e., for each individual connection between a specific asset manager and broker dealer). The … Connection represents the value-added technological expertise that clients are seeking when they purchase … services from Taxpayer.

(3) *… Support:* … Support entitles subscribers to support for an operational problem relating to any transmission made or attempted over the …. … Support charges are for hours of support and are applied regardless of the number of counterparties that the subscriber connects with. The service represents an outsourced information technology ("IT") function for Taxpayer's clients who require additional IT assistance. Unlike the … Connection, which is support specific to each per pair connection, … Support is "general." … Support provides clients with access to its technical support desk and to its product updates and patches, not separately stated when invoiced.

Issue:

Your issue as stated in your February 16, 2006 letter is as follows:

Whether the revenue received from each of Taxpayer's … charges – … Network Access, … Connection, and … Support charges – are exempt from Arizona TPT pursuant to A.R.S. § 42-5064(A), as an internet service provider.

Conclusion and Ruling:

A.R.S. § 42-5064(A) provides that the telecommunications classification does not include sales of internet access services to the person's subscribers and customers. Therefore, sales of services in the category of internet access are not subject to TPT.

Taxpayer is in the business of providing their clients a connection to trade their stocks, fund and other financial transactions. In the first of the three … charges, "… Access Charge," they sell their clients bandwidth (a line of communication), and circuits to connect through. The Taxpayer buys routers and circuits from a telecommunications company. The telecommunications company passes on the tax to the Taxpayer when the Taxpayer purchases the routers and circuits, then the Taxpayer charges the total cost back to their client in the first of three … charges. Taxpayer provides the routers and circuits only to their subscribers for access to the Taxpayer's financial network and therefore, the routers and circuits are not considered to be leased to the subscribers. The sale of the equipment to, or the purchase of the equipment by, the Taxpayer is subject to transaction privilege or use tax since the items are an integral part of the business of providing the financial network.

The second charge, the … Connection Charge, is billed to the "Seller" of the financial product transaction. It is for the connection to a specific IP address of a specific "Buyer."

The last charge, the … Support Charge, is to make sure that whichever systems the Buyers and Sellers have, they will be able to connect and communicate with each other over their network. It provides the client with technology support services, as well as product updates and patches.

Accordingly, the Department rules the following:

- Based on the description of … Network Access, Taxpayer is engaged in selling private internet access services, which is exempt from TPT. Additionally, Taxpayer provides its clients routers necessary to utilize Taxpayer's service, which are returned to the Taxpayer upon cancellation of their service. The routers are an integral part of providing the private network services. This service charge is a charge for private internet access, exempt from TPT under A.R.S. § 42-5064(A).

- Based on the description of … Connection, the charge for these services are for connections to specific IP addresses within the private internet, and they do not include charges for taxable retail sales. Therefore, it is exempt from TPT under A.R.S. § 42-5064(A).

- Based on the description of … Support, Taxpayer provides clients with access to its technical support desk and to its product updates and patches. The charge includes both technology support services – services exempt from TPT, as well as product updates and patches – retail sales of tangible personal property subject to TPT. If the taxable charges are not shown separately from the non-taxable charges the total amount is subject to tax. Arizona Administrative Code ("A.A.C.") R15-5-105. Therefore, the … Support charge is wholly taxable.

Businesses subject to TPT under the telecommunications classification may offer "bundled transactions" to their customers. A.R.S. § 42-5064(E)(1) defines a bundled transaction as "a sale of multiple services in which . . . (a) [t]he sale consists of both taxable and nontaxable services . . . [and] (b) [t]he telecommunications service provider charges a customer one sales price for all services that are sold instead of separately charging for each individual service." Pursuant to A.R.S. § 42-5064(D), a business must be able to reasonably identify the portion of the sales price of a bundled transaction derived from charges for nontaxable services to overcome the Department's presumption of taxability for the entire gross income derived from the sale. The burden of proof is on the telecommunications service provider to establish that the gross proceeds of sales or gross income is derived from charges for nontaxable services. To meet its burden of reasonably identifying the nontaxable portion of gross income derived from bundled transactions, a telecommunications service provider may use allocation percentages, which are further addressed in A.R.S. § 42-5064(D)(1) and (D)(2).

The conclusions in this private taxpayer ruling do not extend beyond the facts presented in your correspondence dated February 16, 2006.

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 applicable only 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.

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