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Governor

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Director

## PRIVATE TAXPAYER RULING LR07-006

December 19, 2007

The Department issues this private taxpayer ruling in response to your letter of February 16, 2007, as supplemented by your facsimile of October 16, 2007, requesting a ruling on behalf of your client . . . ("Taxpayer").

### **Statement of Facts:**

The following facts are excerpted from your February 16 letter:

Taxpayer is a software developer and computer services company. . . . Taxpayer licensed its software for use by a customer located in Arizona (AZ customer) and also entered into an agreement to provide web hosting services to AZ customer via the Internet.

Under the web hosting agreement, AZ customer is allowed to:

- Access Taxpayer's computer network which is located outside of Arizona,
- Store its data on Taxpayer's computer network,
- Retrieve its data from Taxpayer's computer network and
- Receive daily administrative tasks from [T]axpayer's employees such as data backup and file maintenance. Taxpayer's employees are located outside Arizona.

The charges for the software, its installation, software upgrades and support are billed separately from the web hosting services. Transaction [privilege] tax is collected [sic, paid] on the software charges. Taxpayer has charged [sic, paid] transaction [privilege] tax on the web hosting fee.

With the February 16 letter, you included a summary of the services Taxpayer provides:

### **[SYSTEM] Application Service Provider (ASP)**

With the [SYSTEM] ASP (Application Service Provider) solution, we will host and manage the [SYSTEM] applications from our facilities. We will provide the on-going support, maintenance, and upgrades of the applications, hardware, and operating system.

....

### **Features and Benefits**

- System Administration: [SYSTEM] performs daily administrative tasks. We address the installation, upgrade, support and file maintenance of the [SYSTEM] application and database servers, operating system, database, and application files.

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- Security Administration: [SYSTEM] provides secure data transmission paths from each client workstation to the [SYSTEM] servers. User IDs, passwords, and application access rights for the VPN (Virtual Private Network) and the [SYSTEM] application are administered by [SYSTEM] with the client's final approval.
- Hardware Performance Maintenance: [SYSTEM] supplies and maintains all necessary hardware required to provide workstation access to the [SYSTEM] applications at standard industry performance levels. All repairs, upgrades, and replacements to server hardware are the responsibility of [SYSTEM].

....

- IT Management Reports: [SYSTEM] supplies monthly management reports containing detailed information regarding access, usage, performance, and availability for all hosted applications.
- Easy Budgeting: The lease is a set fee, flattening the peaks and valleys associated with the acquisition of software and services. Leasing dramatically lowers initial costs. It provides a consistent quarterly fee that can be easily budgeted.
- No Secondary Operational Fees: No additional fees, such as maintenance and support[,] are required.

In a sample contract enclosed with the February 16 letter, the following terms were provided in a portion dealing with the software license agreement:

**1) Software Product License**

a) Upon Client's payment for the software products listed on the cover of this Agreement, for the license fees set forth in the Investment Summary, [SYSTEM] shall grant to Client and Client shall accept from [SYSTEM] a non-exclusive, nontransferable, nonassignable license to use the software products and accompanying documentation and related materials for internal business purposes of Client, subject to the conditions and limitations in this Software License Agreement.

....

h) The term of the license granted by this Section shall be perpetual.

....

**11) Cancellation or Termination.** In the event of cancellation or termination of this Software License Agreement, Client will make payment to [SYSTEM] for all software products, services and expenses delivered or incurred prior to the termination or cancellation of this Software License Agreement.

In the supplemental October 16 facsimile, you provided the following clarifying details:

The software discussed in the licensing agreement has nothing to do with the web hosting service. It is separate and apart [from] the web hosting service.

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The language used in the ASP (web hosting) that refers to "leasing software" is a discussion of the benefits of purchasing an ASP agreement. If the client chooses to enter into an ASP, they are "leasing" the use of [Taxpayer]'s servers, storage hardware and the software that operates the system. However, all of these items are located in Maine.

The web hosting services are optional. They may be purchased independent of the software purchase the client has made.

Maintenance and support agreements for the client's software are optional. But, they have nothing to do with the web hosting service.

### **Your Issue:**

Is Taxpayer's gross income derived from hosting prewritten software that it sells to its customers subject to Arizona transaction privilege tax?

### **Your Position:**

You state that Taxpayer does not advocate a particular conclusion.

### **Conclusions and Ruling:**

Based on the facts presented, the Department concludes that the transactions undertaken with Taxpayer's software license agreement constitute retail sales of tangible personal property. Arizona Revised Statutes ("A.R.S.") § 42-5001(13) broadly 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 . . . of tangible personal property or other activities taxable under this chapter, for a consideration, and includes:

- (a) Any transaction by which the possession of property is transferred but the seller retains the title as security for the payment of the price . . . .

The tax base for the A.R.S. § 42-5061 retail classification for Arizona transaction privilege tax is limited to the business of "selling" tangible personal property "at retail," which A.R.S. § 42-5061(U)(3) limits to sales "for any purpose other than for resale in the regular course of business in the form of tangible personal property, *but transfer of possession, lease and rental as used in the definition of sale mean only such transactions as are found on investigation to be in lieu of sales as defined without the words lease or rental*" (emphasis added). Transfers of possession, leases, and rentals are instead subject to transaction privilege tax under the personal property rental classification found at A.R.S. § 42-5071.

Taxpayer's software license agreement provides a customer, for a consideration, with the defined right of use of prewritten software for a perpetual term. The perpetuity of the customer's software license does not end with the termination or conclusion of any accompanying maintenance agreement or software web hosting agreement, and the customer is not required to discontinue use of or return software copies to Taxpayer.

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Rather, even upon termination of a web hosting agreement, Taxpayer's customer retains all software licenses that Taxpayer sold to it. As such, Taxpayer's software sales are retail sales of tangible personal property, the gross receipts of which are subject to transaction privilege tax under A.R.S. § 42-5061. See Arizona Administrative Code R15-5-154(B) (addressing the general taxability of retail sales of prewritten computer software).

Under A.R.S. § 42-5061(A)(2), there is a retail classification exemption for the gross proceeds of sales or gross income derived from "[s]ervices rendered in addition to selling tangible personal property at retail." In *Arizona Transaction Privilege Tax Ruling* TPR 93-31 (May 10, 1993), available online at [www.azdor.gov/ResearchStats/rulings/tp93-31.htm](http://www.azdor.gov/ResearchStats/rulings/tp93-31.htm), the Department provides 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 explains that the three categories "are not intended to be an exclusive listing." Consequently, the A.R.S. § 42-5061(A)(2) exemption can 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.

The software web hosting service Taxpayer offers is optional and nonessential to its retail sales of software. That is, Taxpayer does not require customers to purchase the service as part of their acquisition of the prewritten computer software. Consequently, the charges do not appear to be an integral or essential part of the retail software sales at issue, such that they would be part of Taxpayer's taxable gross proceeds derived from retail sales.\*

Based on the above conclusions, the Department rules that Taxpayer's gross receipts derived from hosting software for a client—the software being prewritten computer software that it sold at retail to the client under the terms provided—are exempt from transaction privilege tax under the retail classification pursuant to A.R.S. § 42-5061(A)(2).

This private taxpayer ruling does not extend beyond the facts presented in your correspondence of February 16 and October 16, 2007.

**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**

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\* Taxpayer should note that the applicability of transaction privilege tax to gross receipts derived from software web hosting charges depends on whether the underlying prewritten software is leased or rented instead of sold at retail. For leased or rented software, associated hosting fees are subject to transaction privilege tax under the personal property rental classification if Taxpayer provides hosting services to Arizona customers for their use (*i.e.*, execution) of the software in Arizona and not exclusively outside of the state. In the lease or rental scenario, the location of the server(s) hosting the prewritten software is irrelevant to the analysis of whether transaction privilege tax applies.

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**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.**

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