PRIVATE TAXPAYER RULING LR09-001

February 3, 2009

The Department issues this private taxpayer ruling in response to your request of December 4, 2008, submitted on behalf of your client . . . (the "Company"). Your letter requests a determination of the applicability of Arizona use tax to Company's purchases of software when hosted outside the state for out-of-state users.

Statement of Facts:

Your December 4 request provides the following excerpted facts:

> [The Company] is a[n out-of-state] headquartered company . . . . The Company's activities within Arizona are solely sales solicitation activities . . . by sales employees who travel to Arizona several times a year and sales brokers within and without Arizona. The Company has no owned or rented offices, property or inventory in Arizona.
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> . . . .
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> The Company uses . . . enterprise software for its production, receivable, payable, purchasing, sales and accounting functions. The software was licensed in [State A] . . . by electronic download and no [State A] sales or use tax liability was incurred on the initial license or subsequent upgrades. The software has been hosted by a third party in [State A] and the Company wishes to transfer hosting to a company whose computer center resides in Arizona. The software is accessed by employees at locations in which Company has offices[,] including [State A and several other states]. Access to the software by sales employees is incidental to their sales function. In the future, brokers might access the software, but currently, brokers access . . . licensed software residing on [the Company]'s computers in [State A]. Also, it is possible that the Company may hire Arizona resident employees in a sales or other capacity.
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> Periodically, the [C]ompany acquires maintenance and upgrade releases which are installed on the server pursuant to annual agreements with the software provider.

You supplement your ruling request with a copy of the Software License Agreement (the "Agreement") between the Company a third-party software company ("Software Company"):

> This Agreement is made effective as of the 28th day of December, 2006, by and between [Software Company] . . . and [the Company] . . . ("Licensee").
> 1. DEFINITIONS.
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> * * * *

1.2 "Business Partner" means an entity that requires access to the Software in connection with the operation of Licensee's business, such as customers, distributors and suppliers.

. . . .

1.5 "Named Users" means any combination of users licensed under this Agreement.

1.6 "Proprietary Information" means: (i) with respect to [Software Company] and [Software Company's parent] (the licensor of the [Software Company] Proprietary Information to [Software Company]), the Software and Documentation, any other third-party software licensed with or as part of the Software, benchmark results, manuals, program listings, data structures, flow charts, logic diagrams, functional specifications; (ii) the concepts, techniques, ideas, and know-how embodied and expressed in the Software and (iii) information reasonably identifiable as the confidential and proprietary information of [Software Company] or Licensee or their licensors excluding any part of the [Software Company] or Licensee Proprietary Information which: (a) is or becomes publicly available through no act or failure of the other party; or (b) was or is rightfully acquired by the other party from a source other than the disclosing party prior to receipt from the disclosing party; or (c) becomes independently available to the other party as a matter of right.

* * * *

1.10 "Use" means to activate the processing capabilities of the Software, load, execute, access, employ the Software, or display information resulting from such capabilities.

2. LICENSE GRANT.
2.1 License.

(a) [Software Company] grants a non-exclusive, perpetual (unless terminated in accordance with Section 5 herein) license to Use the Software, Documentation, other [Software Company] Proprietary Information, at specified site(s) within the Territory to run Licensee's internal business operations and to provide internal training and testing for such internal business operations and as further set forth in Appendices hereto. This license does not permit Licensee to use the [Software Company] Proprietary Information to provide services to third parties (e.g., business process outsourcing, service bureau applications or third party training). Business Partners may have screen access to the Software solely in conjunction with Licensee's Use and may not Use the Software to run any of their business operations.

(b) Licensee agrees to install the Software only on hardware identified by Licensee pursuant to this Agreement that has been previously approved by [Software Company] in writing or otherwise officially made known to the public as appropriate for Use or interoperation with the Software (the "Designated Unit"). Any individuals that Use the Software including employees or agents of Subsidiaries and Business Partners, must be licensed as Named Users. Use may occur by way of an

interface delivered with or as a part of the Software, a Licensee or third-party interface, or another intermediary system.

* * * *

5. TERM.
5.1 Term. This Agreement and the license granted hereunder shall become effective as of the date first set forth above and shall continue in effect thereafter unless terminated upon the earliest to occur of the following: (i) thirty days after Licensee gives [Software Company] written notice of Licensee's desire to terminate this Agreement, for any reason, but only after payment of all License and Premium Support Fees then due and owing; (ii) thirty days after [Software Company] gives Licensee notice of Licensee's material breach of any provision of the Agreement (other than Licensee's breach of its obligations under Sections 6 or 10, which breach shall result in immediate termination), including more than thirty days delinquency in Licensee's payment of any money due hereunder, unless Licensee has cured such breach during such thirty day period; (iii) immediately if Licensee files for bankruptcy, becomes insolvent, or makes an assignment for the benefit of creditors.

5.2. End of Term Duties. Upon any termination hereunder, Licensee and its Subsidiaries shall immediately cease Use of all [Software Company] Proprietary Information. Within thirty (30) days after any termination, Licensee shall deliver to [Software Company] or destroy all copies of the [Software Company] Proprietary Information in every form. Licensee agrees to certify in writing to [Software Company] that it and each of its Subsidiaries has performed the foregoing. Sections 3, 4, 6, 7.2, 8, 9, 11.4, 11.5 and 11.6 shall survive such termination. In the event of any termination hereunder, Licensee shall not be entitled to any refund of any payments made by Licensee.

* * * *

10. ASSIGNMENT. Licensee may not, without [Software Company]'s prior written consent, assign, delegate, pledge, or otherwise transfer this Agreement, or any of its rights or obligations under this Agreement, or the [Software Company] Proprietary Information, to any party, whether voluntarily or by operation of law, including by way of sale of assets, merger or consolidation. [Software Company] may assign this Agreement to its affiliates.

Notwithstanding the foregoing, Licensee shall have the right to assign this Agreement (excluding all third-party software) to any entity headquartered in the United States or Canada which acquires all or substantially all of Licensee's operating assets, or, in the event Licensee is merged or reorganized pursuant to any plan of merger or reorganization, subject to the condition that Licensee provides [Software Company] with: (1) a statement, signed on behalf of the Assignee, that such Assignee agrees to abide by the terms of this Agreement; (2) evidence, satisfactory to [Software Company], of such Assignee's corporate authority to enter into this Agreement; and (3) a copy of the Assignee's most current audited financial statements, in accordance with generally accepted accounting principles consistently applied, showing that such Assignee has a minimum net worth of USD $250 million, to allow Assignee to perform its obligations under this Agreement.

The Agreement contained an Appendix 1, which included the following terms:

1. NAMED USER DEFINITIONS:

1.1 "Professional User" is a Named User who performs operational related roles supported by the Software and includes the rights granted under the Employee User.

1.2 "Limited Professional User" is a Named User who is an employee of Business Partners performing limited operational roles supported by the Software.

1.3 "Employee User" is a Named User authorized to access the licensed software solely for the purpose of executing the following transactions: (1) desktop procurement self-services, (2) Travel planning and expense reporting, (3) talent management self-services including employee appraisals, employee development plans, employee training registration, employee opportunity inquiry and response, (4) read-only analytics. Each Employee User shall access the software solely for such individual's own purposes and not for or on behalf of other individuals.

1.4 "Employee Self Service User (ESS)" is a Named User authorized to access the licensed software solely for the purpose of executing the following HR self-services transactions: (1) employee records maintenance, (2) employee time and attendance entry, (3) employee directory. Each Employee Self Service (ESS) user shall access the software solely for such individual's own purposes and not for or on behalf of other individuals.

1.5 "Developer User" is a Named User who uses development and administration tools provided with the Software for the purpose of modifying, deploying and managing [Software Company] Software. The Developer User (1) does include the rights granted under the Employee User and (2) does not include the rights granted under the (a) Professional User and/or (b) Limited Professional User.

2. LICENSED SOFTWARE: The Software licensed to Licensee pursuant to this Appendix consists of the components identified below and specified as being licensed ("Software"). Only individuals licensed as Named Users hereunder are permitted to Use the [Software Company] Software and third party Software licensed herein (including optional Software). Such Use shall be in accordance with their respective Named User type and in accordance with identified licensed Level. At [Software Company]'s request, Licensee shall deliver to [Software Company] a report, as defined by [Software Company], evidencing Licensee's usage of the Software. [Software Company] agrees that the initial request for such report will occur twenty-four (24) months following the effective date of the Agreement or twelve (12) months following the effective date of this Appendix, whichever occurs later, and will continue annually thereafter.

Licensed [Software Company] Software may utilize limited functionality of other [Software Company] Software products. Unless Licensee has expressly licensed (under this or a separate Appendix) the other [Software Company] software utilized by the licensed [Software Company], Licensee's Use of such other [Software Company] Software is limited to access by and through the

other [Software Company] Software for the sole purpose of enabling performance of the licensed [Software Company] Software.

* * * *

4. **INSTALLATION:** For Software to be installed on a specific Licensee or Affiliate Designated Unit within the Territory, Licensee shall provide [Software Company] with written notice of the type/model and serial number and location of each Designated Unit and the number of Users allocated to each such Designated Unit prior to such installation. Such notice shall be in a form materially similar to Schedule 1 attached hereto . . . .

* * * *

6. **MAINTENANCE FEE AND PAYMENT:** Maintenance service offered by [Software Company] is set forth in the Maintenance Schedule to the Agreement. Maintenance Fees shall commence as of the first day of the month following initial delivery of the Software.

The Maintenance Fee for the Software licensed under this Appendix is priced at the then current factor in effect (currently 17%) multiplied by the then current Net License Fee for the licensed Software. . . .

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10. **NAMED USER/SOFTWARE EXCHANGE OPTION:** Until December 31, 2008, Licensee shall have the option, twice per calendar year, to exchange any number of the licensed Named Users and/or Software for a one hundred percent (100%) credit of the List Price license fees for such licensed Named Users or Software under this Appendix, to be applied towards the licensing of additional Named Users and/or [Software Company] Software that have been delivered and licensed hereunder (excluding third party software and Third Party Database) as set forth in this Appendix based upon the Unit list Price(s) and List Price License Fee(s). In the event [Software Company] Software, other than Named Users is exchanged, 100% of such licensed Software metric must be exchanged and Licensee shall discontinue Use of such exchanged Software. Upon written notice from Licensee regarding its exercising of such exchange option, [Software Company] will issue an Amendment to this Appendix modifying the Named User count or Software metric. In the event such exchange results in additional Named Users or a Software metric beyond the total quantity of Named Users or Software metric licensed herein such that the total List Price of those Named Users or Software received exceeds the total List Price of the Named Users or Software exchanged or requires the licensing of third-party software, then Licensee shall be responsible for all additional Software and Named User License Fees (including third-party software fees). There shall be no refunds or credits based on such exchanges.

You also supplement your request with a copy of the Statement of Work ("SOW") between the Company and its third-party hosting services provider ("Hosting Company").

Your Issues:

Based on the arguments presented in your request, Company raises the following issues:

1. Will the transfer of licensed computer software currently hosted in [State A], on which no [State A] sales or use tax liability has been incurred, to a hosting server in Arizona, owned by an unrelated third party, result in an Arizona use tax liability?

2. Will the fees related to the maintenance and upgrade releases be subject to Arizona transaction privilege or use tax?

Your Positions:

Company's position is that the use of the software and maintenance and upgrade software will occur outside of Arizona, and therefore no tax is due resulting from the hosting of the software on an Arizona server.

Conclusions and Ruling:

Arizona transaction privilege tax it is a tax on the privilege of conducting business in the State of Arizona and is imposed upon the seller or lessor, who may pass the burden of the tax on to the purchaser or lessee but is the party that remains ultimately liable to Arizona for the tax. The tax is imposed under sixteen tax classifications, with exclusions and deductions separately provided for under each classification. The retail classification, found at Arizona Revised Statutes ("A.R.S.") § 42-5061, imposes transaction privilege tax on a person's gross proceeds of sales or gross income derived from "the business of selling tangible personal property at retail." 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 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). Other transactions that constitute "sales" of tangible personal property—namely, 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.

While there is a corresponding Arizona use tax liability for retail sales of tangible personal property to Arizona purchasers on which transaction privilege tax is not due, no such corresponding use tax exists for transaction privilege tax imposed on leases and rentals of tangible personal property.[1]

Tangible Personal Property

Regarding electronically-transferred software applications such as the one at issue in this private taxpayer ruling, it is important to first understand what constitutes "tangible personal property." For the purposes of Arizona transaction privilege and use taxes, tangible personal property is much more than physical goods that a person can hold, touch, or feel. As defined since the 1935 Act, it is property "which may be seen, weighed, measured, felt or touched *or is in any other manner perceptible to the senses*" (emphasis added).

Consistent with this broad definition, Arizona courts have held in decisions from 1943 forward that items such as music played from a jukebox and electricity are tangible personal property subject to transaction privilege tax.[2] Consequently, when Arizona imposes tax on a copy of a movie, book, or software application, it is not a tax based on paper, CD-ROM, or DVD. It is a tax on that copy *as tangible personal property itself*. It is irrelevant, for tax purposes, how a vendor chooses to transfer the copy to the buyer or lessee, whether it is by using a physical storage device like paper or a disc, or by electronic means. In either case, it would still constitute a sale of tangible personal property that may be subject to tax.

Generally, leases of tangible personal property are taxable when Arizona lessees use the property in this state on a non-temporary basis. If an Arizona lessee moves out of state with the property, the lessor's gross income from subsequent lease payments will no longer be taxable if the lessee uses the property exclusively outside the state. Unlike the tax structure for retail transaction privilege tax, there is no general exemption for categories of nontaxable services related to a lessor's business of leasing or renting tangible personal property.

Transaction privilege tax on software licenses is imposed based on where the lessees compiled and executed the applications and generated data files using the applications. The server location where the software and files are "physically" stored makes no difference for tax purposes. Again, the location where the lessee uses the leased property on a non-temporary basis is what is determinative.

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[1] *See* Arizona Administrative Code ("A.A.C.") R15-3-2302 for more information on the scope of Arizona use tax.

[2] *See State Tax Comm'n v. Marcus J. Lawrence Mem. Hosp.*, 108 Ariz. 198, 495 P.2d 129 (1972) (en banc); *State v. Jones*, 60 Ariz. 412, 137 P.2d 970 (1943). The broad scope of Arizona's definition has even been noted by another state's supreme court. *See* Ramco, Inc. v. Director, 248 N.W.2d 122, 124 (Iowa 1976).

The following two scenarios summarize these positions of the Department:

1. *Scenario 1*: A lessor hosts software on servers in Arizona and licenses the software applications on an annual basis to an out-of-state lessee. Every year, the lessee can pay to renew or choose to cancel. If the lessee chooses to cancel, it must return any copies of the software and can no longer use the software.

   Tax consequence for Scenario 1: The lessor's gross income from the software licenses for the out-of-state lessee is *nontaxable* because the lessee uses the software exclusively outside the state.

2. *Scenario 2*: A lessor hosts software on out-of-state servers and licenses the software applications on an annual basis to an Arizona lessee. Every year, the lessee can pay to renew or choose to cancel. If the lessee chooses to cancel, it must return any copies of the software and can no longer use the software.

   Tax consequence for Scenario 2: The lessor's gross income from the software licenses for the Arizona lessee is *taxable* because the lessee uses the software in Arizona on a non-temporary basis.

Ruling

Based on the facts and documentation provided, the Department rules as follows:

1. Company's transfer of licensed, prewritten computer software hosted in [State A], on which no [State A] sales or use tax liability has been incurred, to a hosting server in Arizona, owned by an unrelated third party, does not result in an Arizona use tax liability. Company's software licenses constitute leases of tangible personal property, transactions for which there is no corresponding use tax liability. The hosting of computer software on servers located within this state alone does not affect the taxability of sales or leases involving the underlying software.

2. Fees imposed by Company's software provider related to the maintenance and upgrade releases may be subject to Arizona transaction privilege tax under the personal property rental classification, insofar as such fees relate to maintenance and upgrades to software licensed for any of Company's Arizona-based users of the software. Nevertheless, as Company is not the taxpayer for the purposes of any Arizona transaction privilege tax liability on the gross receipts derived from such leases, the Department does not make a definitive ruling as to software provider's transaction privilege tax liability for its gross receipts derived from such fees.

This private taxpayer ruling does not extend beyond the facts presented in your letter and enclosed documents of December 4, 2008.

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, or introduced into evidence in any proceeding by a taxpayer other than the taxpayer who has received the private taxpayer ruling.

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