PRIVATE TAXPAYER RULING LR10-009

March 31, 2010

The Department issues this private taxpayer ruling in response to the ruling request dated June 23, 2008 (submitted on February 11, 2009) on behalf of your client, . . . ("Company"), and the additional information and documentation provided on April 3 and December 9, 2009. You request the Department to rule as to the applicability of Arizona transaction privilege tax to income derived from Company's leases of pallets to its manufacturer customers who use the pallets to transfer products to distributors, and fees charged to the distributors who are separately contractually obligated to return the pallets to Company.

Statement of Facts:

The following facts are excerpted from your letter dated June 23, 2008:

> [Company] is in the business of leasing pallets to manufacturers who use the pallets to package and ship their products to customers (or "distributors"). The pallets that [Company] leases to the manufacturers serve identical functions from the manufacturer perspective as those that may be purchased from other pallet vendors. (Footnote: For pallets that [Company] leases, [Company] retains title to the pallets at all times, as the manufacturer never has title to these pallets. The manufacturers use the pallets one time only prior to relinquishing possession of the pallets.) Likewise, the price of the manufactured goods ultimately purchased by any customer remains constant regardless of whether a manufacturer employs a leased pallet or a purchased pallet to deliver the respective products. Through the sale of the respective manufacturer products to third party customers, the manufacturers use the pallets one time only. Accordingly, the manufacturers' intention to use the pallets one time only remains constant regardless of whether the manufacturers acquire a pallet through purchase or lease to deliver their products.
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> Generally, manufactured items are placed on the pallets and secured with the use of load formers, corner posts, and stretch or shrink wrap. The combination of these packaging materials encompasses the products and pallet jointly and restrains the products from moving downward or side-to-side. These assembled pieces—the manufactured products and the pallet packaging materials—are sold by the manufacturer to the third party customers as one unit load. Consequently, the manufacturer generally charges its third party customer by the unit price, constituting the manufactured products inclusive of the pallet packaging materials without a separate charge for any of the items used to ship and package the products.

[Company] has a billing system based upon multiple prongs (all of which are separately enumerated and priced in the contracts by and between [Company] and the respective manufacturers or distributors), including the following:

1. The manufacturer is initially charged an "issue fee" when a pallet is sent from [Company's] pooling manager to a manufacturer. This fee is a one-time flat fee charged to manufacturers on a per pallet basis.
2. The manufacturer may be assessed a fuel surcharge depending on the terms of the contract.
3. The manufacturer is charged a daily rental fee based upon the number of days that a particular pallet remains in the manufacturers' possession preceding shipment of its products to customers or distributors. This rental fee ceases when the manufacturer sends its product (packaged on the pallet) to the distributor.
4. The manufacturer is also charged a one-time flat fee referred to as a "transfer fee" when a manufacturer delivers its product (on the pallet) to the distributor.
5. To the extent that a pallet received by either a manufacturer or a distributor is lost while in their respective possession (difference in pallet numbers and system balance), the corresponding manufacturer or distributor is charged a "lost equipment fee" to recoup [Company's] costs related to locating and recovering the lost pallet or purchasing new/replacement pallet. . . .
6. The distributors may be charged a collection fee for a portion of [Company's] cost for transporting the pallets to the pooling site for inspection, potential repair, and redistribution into the pool.

After receipt of the goods by the distributor, the manufacturer relinquishes all responsibility for and possession of the pallet. Arrangements are made between the pooling manager and the distributor to recover the pallet. Regardless of the amount of time a distributor holds the pallet on its premises, the manufacturers' daily rental fee ceases upon transfer of possession of the pallet (concurrent with transfer of the manufactured products contained on the pallets) from the manufacturer to the distributor. . . . In all instances the distributor is barred from returning the pallet to anyone other than the pooling managers.

Furthermore, the manufacturers generally do not pay Transaction Privilege Tax on any of the other packaging-related components of the unit load (including the corner posts and stretch wrap) delivered to their customers. [Company's] manufacturing customers are, however, currently paying Transaction Privilege

> Tax to [Company] on the leased pallets, including on the issue fee charge as well as the daily rental fee.
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> [Company] maintains an accessible supply of pallets to meet its various customers' (the various manufacturers) requirements. As conveyed above, the pallets are issued to the manufacturers, and [Company] receives payment . . . for the daily rental of the pallets. From the manufacturer's perspective, the manufacturer procures the requisite number of pallets from [Company], packages the manufactured products on the pallets for subsequent sale to distributors, and then transfers possession of the pallets containing the products to the various distributors for sale of the product. The distributors store the loaded pallets at their respective facilities pending unloading of the products. The distributor (and not the manufacturer of the product loaded on the pallet) is required to return the empty pallets to [Company]. The distributor will never send back to the manufacturer a pallet that previously was used for packaging the manufacturer's products. In addition, when the pallets are returned to [Company], a significant portion of the pallets must be substantially reconstructed due to destruction of the pallets.
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> In sum, once the manufacturer delivers the loaded goods to the distributor, it no longer has possession or subsequent control of the pallets. Accordingly, the manufacturers lease the pallets from [Company] with the intent to use the pallets one time only as packaging materials for sale or shipment of their products to distributors.

Clauses within the separate contractual agreements with the manufacturers and distributors respectively stipulate the following:

> … [Company] never sells or transfers ownership of its Equipment. Customer acknowledges and agrees that each item of Equipment has a special value to [Company] and that [Company] repairs, maintains, handles and otherwise administers the circulation of all Equipment as part of a pool. . . . Customer acknowledges and agrees that, despite any other clause in this Agreement, [Company] remains the owner of the Equipment at all times. Neither Customer nor any other person is entitled to purchase or sell the Equipment, or use, dispose of or otherwise deal with Equipment in any way that is inconsistent with [Company's] ownership of the Equipment or the terms of this Agreement.
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> . . . [Company] is the exclusive owner of all [Company] pallets and never sells them. [Company] rents them and only allows them to be used by authorized parties. You agree that you have no ownership interest whatsoever in any

> [Company] pallets and that you have no right to sell, use or deal with [Company] pallets in any manner other than as specifically permitted herein.

Issues:

1) Does Company's lease of pallets to a manufacturer constitute a nontaxable sale for resale, because the manufacturer relinquishes control of the pallets once they are shipped to the manufacturer's distributor customer?

2) If the income derived from Company's lease of pallets to a manufacturer is subject to the transaction privilege tax imposed under the personal property rental classification, is the income derived from all of the contractual charges subject to the transaction privilege tax?

3) Is the income derived from Company's fees or other charges received from distributors pursuant to the "[Company] Distributor Agreement" subject to transaction privilege tax?

Your Position:

Your position is that Company's leases of pallets to its customers are exempt from transaction privilege tax as "sales" of tangible personal property leased for resale.

Discussion

Arizona's transaction privilege tax differs from the sales tax imposed by most states. The transaction privilege tax is imposed on the privilege of conducting business in the State of Arizona. Differing from a true sales tax, the transaction privilege tax is levied on income derived by the *seller* or *lessor*, who is legally allowed to pass the economic expense of the tax on to the purchaser or lessee. However, the seller or lessor is ultimately liable to Arizona for the tax.

The primary issue in Company's private taxpayer ruling request relates to a provision under the retail classification which excludes sales of tangible personal property for resale in the ordinary course of business from taxation. Company posits that taxpayer's *leases* of pallets to its manufacturer customers constitute sales for resale, because the definition of a "sale" includes the terms "lease or rental," and a "sale" can be merely a "transfer of … possession." Therefore, according to Company's analysis, "any exemption defined in terms of a 'sale' … also applies, in each instance, to a lease of tangible personal property."

A.R.S. § 42-5001(13) defines the term "sale" broadly, because this word is used in many contexts in the transaction privilege tax statutes. The tax bases for all of the sixteen transaction privilege tax business classifications are described as "the gross proceeds of sales or gross income derived from the business." A.R.S. § 42-5001 also defines "gross income," "gross proceeds of sales," "gross income," and "gross receipts," and because these definitions apply to the tax bases of all of the sixteen business classifications, the broad definition for "sale" is very pertinent.

A.R.S. § 42-5061 *Retail classification*, imposes the transaction privilege tax upon persons engaged in the business of selling tangible personal property at retail. A.R.S. § 42-5001(12) defines a "retailer" to include "every person engaged in the business classified under the retail classification …" A.R.S. § 42-5061(V)(3) excludes "sales for resale" by a retailer from taxation under the retail classification by defining "[s]elling at retail" in pertinent part as "a sale for any purpose other than for resale in the regular course of business in the form of tangible personal property . . ." This exclusion under the retail classification has no application to a person engaged in business under the personal property rental classification.

Exemptions under one business classification cannot be claimed by a person subject to the transaction privilege tax under a different business classification. *See Brink Electric Construction Company v. Arizona Department of Revenue*, 184 Ariz. 354, 909 P.2d 421, (App. 1995). The A.R.S. § 42-5001(13) definition of "sale" as including a "lease or rental" does not authorize statutory exemptions under one business classification to apply under a separate statutory business classification.

A.R.S. § 42-5071 *Personal property rental classification,* imposes the transaction privilege tax on businesses that lease or rent tangible personal property for a consideration. The tax base for this classification is the gross proceeds of sales or gross income derived from the business. The income derived from a lease of tangible personal property in Arizona is subject to tax under the personal property rental classification unless specifically exempted by statute. Company's business of leasing pallets for a consideration to manufacturers who use the pallets to package and ship their products to customers (or "distributors"), or to distributors who incur rental charges for any use of the pallets not expressly authorized by the "[Company] Distributor Agreement," are activities that are taxable under the personal property rental classification.

A.R.S. § 42-5071 provides specific exclusions and deductions from the personal property rental classification tax base, some of which cross reference to deductions provided under the retail classification by A.R.S. § 42-5061. A.R.S. § 42-5071 does not provide an exclusion or deduction that cross references to A.R.S. § 42-5061(V)(3) or

that would otherwise apply to the income derived from Company's leases of pallets to its manufacturer lessees.

Arizona Administrative Code R15-5-1502(D) provides that the "[g]ross income from the rental of tangible personal property includes charges for installation, labor, insurance, maintenance, repairs, pick-up, delivery, assembly, set-up, personal property taxes, and penalty fees even if these charges are billed as separate items, unless a specific statutory exemption, exclusion, or deduction applies."

[Company] argues that *Shamrock Foods Co. v. City of Phoenix*, 157 Ariz.286; 757 P.2d 90 (1988), establishes a broad interpretation of the resale exemption and applies to its leases of pallets to its customers. In *Shamrock*, the Arizona Supreme Court held that the City of Phoenix's privilege tax did not apply to retail sales of noncontainer paper and plastic products such as napkins, straws, and coffee stirrers to restaurants that transferred these items to its customers, because the cost of these items was a part of the price paid for a meal by the restaurant's customers.

Company's reliance on *Shamrock* is misplaced because Company leases the pallets to its manufacturer customers, and the manufacturers neither resell nor release the pallets to the distributors. As the contractual agreements repeatedly state, "[Company] never sells or transfers ownership of its Equipment." . . .

Conclusion and Ruling

Company is subject to transaction privilege tax under the personal property rental classification on the income derived from the lease or rental of pallets to manufacturers and distributors. There is no "sale for resale" deduction under the personal property rental classification that applies to the income derived from Company's leases.

Company's gross income derived from engaging in business under the personal property rental classification (as clarified by A.A.C. rule R15-5-1502) is subject to transaction privilege tax, including income derived from the following sources:

1. The "issue fee" charged to the manufacturer.
2. The fuel surcharge.
3. The daily rental fee.
4. The transfer fee.
5. Lost equipment fees charged to manufacturers and distributors.
6. Collection fees charged to distributors.

The conclusions in this private taxpayer ruling do not extend beyond the facts presented in the correspondences dated June 23, 2008 and April 3, 2009.

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.

Lrulings/10-009-D