TAXPAYER INFORMATION RULING LR11-005

April 19, 2011

This taxpayer information ruling is in response to your letter dated March 30, 2010, as supplemented by your letter dated April 23, 2010, in which you requested a taxpayer information ruling on behalf of an undisclosed client ("Company"). Specifically, you requested a taxpayer information ruling regarding the applicability of Arizona's transaction privilege tax to Company's provision of "Merchandise Return Authorization Services" and "Discount Coupon Services."

Statement of Facts:

The following facts are excerpted from your March 30, 2010 letter:

> 1. Company is a Delaware corporation that is commercially domiciled in California. Company has no permanent employees, offices or assets in Arizona. However, employees may enter the state to visit with potential or existing customers.
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> 2. Company and its related issues are not subject to an existing audit, protest, appeal or litigation in Arizona. To date, Company has not billed or collected transaction privilege or use tax from transactions with Arizona customers.
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> 3. Company's customers are primarily retail Merchants.
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> 4. Approximately ninety-five percent of Company's revenue is derived from the provision of merchandise return authorization services ("Authorization Services") to Merchants. Company's remaining revenue is derived from an add-on service that generates Merchant coupons ("Discount Coupon Services") for customers making returns to the Merchant.
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> 5. A Merchant acquires Company's merchandise Authorization Service to assist it in determining whether the Merchant will or will not accept merchandise returns from one of the Merchant's own customers. The Authorization Service assists Merchants to expedite the handling of returns and reduces the probability of merchandise return fraud. . . .
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> 6. A Merchant uses Company's merchandise Authorization Service when a customer attempts to make a merchandise return to that Merchant. To initiate a transaction, a Merchant must swipe its customer's driver's license or state ID card through a VeriFone or similar platform on a Merchant's point of sale ("POS") system and transmits the information electronically to Company's data center in California, where Company's servers process each transaction and electronically transmits an Authorization Decision back to the Merchant regarding whether to accept or reject the merchandise return.

7. The type of information provided by a Merchant to Company includes the information on the face of an ID, such as the identification number, the customer's name, address, date of birth, and expiration date. Certain additional information is implicitly supplied, such as the time of day or night of the transaction, the address of the Merchant's store where the transaction is occurring, and the type of Merchant. . . . [T]he data is transmitted to Company's host server for an Authorization Decision to approve the return or exchange through utilization of deterministic rules and statistical models.

8. Upon receipt of the information provided by the Merchant, Company performs a two-step analysis at its data center in California. First, the return data described above is run through Company's proprietary, self-created and updated "activity database," which . . . contains all return data that Company has amassed with that specific Merchant. Any historical data that appears linked to the customer's return data (such as the driver's license number) is identified for any "positive" or "negative" indications.

Second, the return data together with any historical return data (gleaned from the foregoing process) is run through Company's "risk scoring system." The risk scoring system consists of a highly proprietary and sophisticated computer model which the Company built in-house. . . . These models perform a risk analysis . . .

9. Company's ultimate goal, by use of its predictive models, is to mitigate the risk to a Merchant from a customer's fraudulent or abusive merchandise return. The aim of Company's process is to develop accurate predictive risk models . . . and thus advise the Merchant as to whether or not to accept a customer's return.

10. Company's risk analysts identify and evaluate . . . variables that may be relevant in determining return risk for a particular Merchant or industry. Each variable is evaluated using proprietary statistical methods and incorporated into multiple models which evaluate customer risk . . . Company's risk analysts determine the relative variables and the relative weights to be assigned to each using Company's . . . methodology, which uses statistical modeling software to perform the analysis.[1] . . .

11. After analyzing the information using the processes described above, Company formulates a communication as to whether a return should be accepted or not, and provides its communication to the Merchant recommending whether the Merchant should accept or decline the merchandise return. . . .

12. The communication provided by Company to a Merchant, whether or not to accept the return, pertains only to the single return transaction of that one customer and that one return. . . . Company charges its customers a separate fee for professional consulting services associated with the initial set-up and integration support services. The fee for Authorization Services is billed separately on a per-store basis as explained more fully below.

[1] While Company utilizes third-party statistical model software in the development of its . . . optimization solution . . . to predict fraudulent and abusive return behavior, Company is not licensing the third-party software to its customers.

13. The result of each merchandise return Authorization Service transaction that is performed by Company for any Merchant is added to Company's in-house activity database . . . Thus, a revised database is used each time a merchandise return Authorization Service analysis is performed by Company.

14. The communication provided to the Merchant, whether or not to accept a particular return, is not provided to anyone other than that specific Merchant who requested that specific merchandise return authorization. . . .

15. In addition, Company offers an add-on service that generates Merchant coupons to customers making returns to the Merchant. . . . For this service (i.e., Discount Coupon Service), Company receives payment in the form of commission based on success, defined as incentives used, not just printed.

16. In providing the Authorization or Discount Coupon Services, Merchants communicate with Company in one of two ways: (i) VeriFone terminals or (ii) Merchant's POS system. For some Merchants, Company may provide countertop VeriFone terminals for the Merchant to use during a brief pilot period . . . Company does not make a separate charge to the Merchant for usage of the terminals. Rather, the terminals remain the property of Company and at the termination of an initial pilot period (ranging from 30 to 90-days), all terminals must be returned to Company. . . . If a Merchant executes an agreement for Authorization or Coupon Services beyond the pilot period, the Merchant will purchase the necessary terminals from third-party vendors. . . . Other than the countertop terminal provided to certain Merchants during the brief pilot period, Company does not provide its customers with any other equipment or communication services for use by the Merchant . . .

17. The structure of the service fee varies depending on the service. For example, the fee for the Authorization Service is generally based upon the number of stores using the service. . . . In contrast, the fee for the Discount Coupon Service is based on a risk model in which Company's fee is equal to an agreed percentage of all net sales generated by purchases made on transactions in which the consumer coupon is redeemed. . . . The fee for each type of electronic information service (i.e., Authorization Services, Discount Coupon Services, or Set-up/Implementation Services) is shown as a separate line item on Company's billing invoice, and the charge for equipment provided during a pilot period, if any, is not separately stated but is included in the service fee on customer billings.

18. While the essence of Company's services has not changed over the years, the Company's contracts have been modified to more accurately describe the nature of the Company's services. Customer invoicing has always been consistent with the fee structure described above.

As part of your March 30, 2010 ruling request, you provided as Exhibit 1 the most recent version of the Company's standard Service Contract with supporting exhibits and order forms for Authorization Services and/or Discount Coupon Services. The following provisions are excerpted from Exhibit 1.

SERVICES AGREEMENT

. . .

9.3 Effect of Termination. Upon the expiration or termination of this Agreement: (a) Client will have no further rights with respect to the Services; (b) Client agrees to exercise due diligence and care to remove all copies of any Company software used in conjunction with the Services from Client controlled hardware and to return to the Company all documentation, electronic disk and electronic tape media or other materials delivered to Client under this Agreement; (c) the Company agrees to exercise due diligence and care to remove all copies of any of Client Data used in conjunction with Services and to return to Client all documentation, electronic disk and electronic tape media or other materials delivered to Company under this Agreement; (d) all fees due or payable as of the termination date shall become immediately due; and (e) all fees earned or unpaid as of the effective date of termination shall become immediately payable to the Company.

. . .

Merchandise Return Authorization Services

Order Form

. . .

Use of RAS. Subject to the terms and conditions of this Order Form and Agreement, the Company hereby grants to Client, during the Term, a non-sublicensable, non-transferable and non-exclusive right to access and use the Return Authorization Service solely within the United States and for the Client Data about United States based Consumers, including the right to use the Return Terminals and the Services Output in connection with its use of the Services. The Company reserves all rights not expressly granted to Client hereunder.

As part of your March 30, 2010 ruling request, you also provided as Exhibit 2 the prior version of the Company's standard Service Contract with supporting exhibits and order forms for Authorization Services and/or Discount Coupon Services. The following provisions are excerpted from Exhibit 2.

Merchandise Return Authorization Services

Order Form

. . .

License to RAS. Subject to the terms and conditions of this Order Form and the Agreement, the Company hereby grants to Client, during the Term, a non-sublicensable, non-transferable and non-exclusive license to access and use: (a) the RAS Remote Software solely on authorized Return Terminals at authorized Client Locations within the United States; and (b) the RAS solely

> within the United States and for the Client Data about United States based Consumers, including the right to use the Services Output in connection with its use of the Services. The Company reserves all rights not expressly granted to Client hereunder.

Issues:

Based on the submitted request, the Company appears to raise the following issues:

1. Are Company's gross receipts derived from providing Merchandise Return Authorization Services, including Set Up/Implementation Services and Authorization Services, subject to Arizona transaction privilege tax?

2. Are Company's gross receipts derived from providing Discount Coupon Services subject to Arizona transaction privilege tax?

Positions:

Company's positions are as follows:

1. Company's gross receipts derived from providing Merchandise Return Authorization Services are not subject to transaction privilege tax.

2. Company's gross receipts derived from providing Discount Coupon Services are not subject to transaction privilege tax.

Applicable Law:

Arizona Revised Statutes ("A.R.S.") § 42-5008 levies a transaction privilege tax measured by the amount or volume of business transacted by persons on account of their business activities.

A.R.S. § 42-5001(13) defines a 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, including consignment transactions and auctions, of tangible personal property or other activities taxable under this chapter, for a consideration."

A.R.S. § 42-5001(16) defines "tangible personal property" as "personal property which may be seen, weighed, measured, felt or touched or is in any other manner perceptible to the senses."

A.R.S. § 42-5061(A) states that "[t]he retail classification is comprised of the business of selling tangible personal property at retail. The tax base for the retail classification is the gross proceeds of sales or gross income derived from the business."

A.R.S. § 42-5061(A)(1) provides a retail exemption for "[p]rofessional or personal service occupations or businesses which involve sales or transfers of tangible personal property only as inconsequential elements."

A.R.S. § 42-5071 imposes the transaction privilege tax under the personal property rental classification. The personal property rental classification is comprised of the business of leasing or renting tangible personal property for a consideration.

A.R.S. § 42-5023 states that "[i]t is presumed that all gross proceeds of sales and gross income derived by a person from business activity classified under a taxable business classification comprise the tax base for the business until the contrary is established."

Arizona Administrative Code ("A.A.C.") R15-5-154 states the following:

> A. Gross receipts derived from services rendered in whole or in part in connection with the sale of computer hardware are exempt, including gross receipts derived from charges imposed for professional and technological services such as analysis, design, support engineering services, classroom instruction, and data conversion services.
>
> B. Except as provided in subsection (C), 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.
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> C. Gross receipts derived from charges imposed for the following business activities originate from nontaxable service activities and are therefore not taxable:
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> > 1. The original creation of an electronic data processing program for the specific use of an individual customer, or
> >
> > 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.

A.A.C. R15-5-1502(D) provides, "[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."

Discussion

A.R.S. § 42-5061 imposes the transaction privilege tax under the retail classification. The tax base for the retail classification is the gross proceeds of sales or gross income derived from the sale of tangible personal property at retail. Retail sales are defined as 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." [2] Transfers of possession, leases, and rentals are instead generally subject to transaction privilege tax under the personal property rental classification.[3]

A.R.S. § 42-5071 imposes the transaction privilege tax under the personal property rental classification. The personal property rental classification is comprised of the business of leasing or renting tangible personal property for a consideration. While there is a specific exemption for professional or personal service occupations or businesses as well as one for services rendered in addition to retail sales of tangible personal property under the retail classification, no similar exemptions exist under the personal property rental classification. A.A.C. R15-5-1502(D) expresses this principle by stating that "[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" (emphasis added). As a result, charges for consulting, education, equipment installation and repair, web hosting, and support services that arise from a lease or rental would be included in a business's taxable gross income under the classification.

Products sold, leased, or rented as part of a business's taxable activities under the retail and personal property rental classifications are not limited to "physical goods," but rather, need only constitute "tangible personal property." As provided in A.R.S. § 42-5001(16), Arizona broadly defines tangible personal property as "personal property which may be seen, weighed, measured, felt or touched or is in any other manner perceptible to the senses." Therefore, when Arizona imposes transaction privilege tax on a copy of a movie, book, or software application, it is not a tax based on paper, CD-ROM, or DVD. Rather, 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 the 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.

Custom Computer Software

Arizona Transaction Privilege Tax Ruling TPR 93-48 addresses the taxation of computer hardware, software, and related services. As TPR 93-48 explains, the sale of prewritten or "canned" software is considered 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 been originally designed for one specific customer but that becomes available for sale to others.

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[2] A.R.S. § 42-5061(V)(3) (emphasis added).
[3] *See* A.R.S. § 42-5071.

As addressed by A.A.C. R15-5-154(B), "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.

Therefore, "custom computer software," software designed exclusively to the specifications of one customer's unique application, is not subject to tax under the retail classification. The sale of such software is considered the sale of a professional service and not subject to tax.

The Department is unable to make a determination regarding whether Company's "fee to provide support for the integration of its Services [Merchandise Return Authorization Services and Discount Coupon Services] with a Merchant's system" [4] meets the definition of "custom computer software." If so, and if Company can show a separate line of business creating custom computer software as explained more fully below, the gross income derived from the creation of such custom computer software is not subject to transaction privilege tax. However, only the gross income derived from the initial creation of the custom computer software is exempt from tax. Fees for the continued lease of the software on a monthly basis, as explained more fully below, are subject to tax under the personal property rental classification.[5]

Separate Lines of Business

A.R.S. § 42-5008 levies a transaction privilege tax measured by the amount or volume of business transacted by persons on account of their business activities. A.R.S. § 42-5023 states that "[i]t is presumed that all gross proceeds of sales and gross income derived by a person from business activity classified under a taxable business classification comprise the tax base for the business until the contrary is established." Although a taxpayer may have more than one business, "[i]f activities are incidental in the sense that they are inseparable from the principal business and interwoven in the operation thereof to the extent that they are in effect an essential part of the major

[4] As explained in Company's original request for a taxpayer information ruling, support for the integration of its Services with a Merchant's system includes assessment of a Merchant's return processes, design of an authorization model based on that Merchant's individual risk model, requirements analysis, user interface changes, or reviewing a Merchant's design for enabling its POS system to communicate with Company's server and related training.

[5] If the "related training" referred to in Footnote 4 is in connection with the retail sale of the software, and fees for such training are separately stated on the invoice and in Company's books and records, the training is exempt from tax under A.R.S. § 42-5061(A)(1). However, if the training is part of Company's lease of software, gross receipts derived from it are subject to transaction privilege tax under the personal property rental classification, regardless of whether separately stated on the invoice or in Company's books and records.

business, they cannot be taxed as a separate business." [6] As a result, income from services that may be nontaxable if carried on by a business that is not otherwise taxable under one classification (*e.g.*, provision of web hosting services only) may nevertheless be part of a taxpayer's gross income from a taxable activity that is the basis of the taxpayer's principal activity.[7]

In *Duhame v. State Tax Commission*,[8] the Arizona Supreme Court held that transaction privilege tax is measured by all of the business activity of a taxpayer rather than merely a part of it. Nevertheless, the Court later found that a person's activities may constitute more than one business and the taxpayer would be obligated to pay the appropriate tax on each business. *Trico*, 288 P.2d at 784.

In 1976, the Arizona Supreme Court again addressed the principle in *State Tax Commission v. Holmes & Narver, Inc.*[9] After stating that not all business is subject to transaction privilege tax (*i.e.*, only those businesses specifically set forth in the statutes), the Court set forth the following three-part test to determine when a service is not part of a major business:

1. The portion of the business that is the service in issue can be readily ascertained without substantial difficulty;
2. The revenues from the service, in relation to the taxable revenues of the business, are not inconsequential; and
3. The service cannot be said to be incidental to the other taxable activity.

In 1995, the Arizona Court of Appeals elaborated on the *Holmes & Narver* test, noting that "when the amount involved is not minimal, when it can be easily calculated, and when the service it relates to is not an integral part of the main business, the main and ancillary services can be separated for tax purposes." [10] The court determined that income from concededly nontaxable activity (the sale of gasoline) was part of the personal property rental classification tax base for city tax purposes. In so holding, the Court of Appeals stated:

> In summary, we conclude that because every Budget car rental contract includes a refueling charge, the charge is an integral part of Budget's car rental business. Because most customers return with a full gas tank, thus avoiding the refueling charge, the charge accounts for a minimal percentage of Budget's car rental business. Accordingly, refueling charges paid to Budget are taxable as gross income from the car rental business.[11]

Consequently, a taxpayer's receipts from customers designated as payments for services actually provided by a third party (and resold by the taxpayer) could be

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[6] *Trico Elec. Coop. v. State Tax Comm'n*, 288 P.2d 782, 784 (Ariz. 1955).
[7] *Walden Books Co. v. Ariz. Dep't of Revenue*, 12 P.3d 809, 813-14 (Ariz. Ct. App. 2000).
[8] 179 P.2d 252 (1947).
[9] 548 P.2d 1162 (en banc).
[10] *City of Phoenix v. Ariz. Rent-A-Car Sys.*, 893 P.2d 75.
[11] 893 P.2d at 80.

considered part of the business's taxable receipts as being interwoven in and an integral part of the taxpayer's business. This result would occur even though, under another tax classification, such receipts might be nontaxable.

Software Licenses

The Company's original request for a taxpayer information ruling states the following:

> While Company utilizes third-party statistical model software in the development of its . . . optimization solution . . . to predict fraudulent and abusive return behavior, Company is not licensing the third-party software to its customers.

However, after careful review of Company's exhibits submitted with its request for a taxpayer information ruling,[12] the Department has determined that the "proprietary, patented, real-time model based optimization solution" is a taxable software license.

As explained in detail in Taxpayer Information Ruling LR10-007, a software license is different from arrangements that fall under the general "license" nomenclature used for leases and rentals of physical tangible personal property (*i.e.*, property that can be touched or felt). Virtually all sales of prewritten software are sales of nonexclusive rights to use, regardless of whether they are sold on physical media or transmitted electronically or whether they have perpetual or limited terms. Because of the interplay of federal copyright laws and the difference in the meaning of the terms "sale" and "license" as used in the Copyright Act[13] compared to common law applications used in Arizona tax law cases, a software license should not be confused with the common law concept of license.[14] Tax treatment is based upon the rights that arise from a particular contractual arrangement; merely relying on how the arrangement is labeled can be misleading.

The earlier version of Company's standard service contract that was submitted with the Company's ruling request includes the following language:

> License to RAS [Return Authorization Services]. Subject to the terms and conditions of this Order Form and the Agreement, the Company hereby grants to Client, during the term, a non-sublicensable, non-transferable and non-exclusive license to access and use: (a) the RAS Remote Software solely on authorized Return Terminals at authorized Client Locations within the United States; and (b) the RAS solely within the United States and for the Client Data about United States based Consumers, including the right to use the Services Output in

[12] Exhibit 1: Most recent version of the Company's standard Service Contract with supporting exhibits and order forms for Authorization Services and/or Discount Coupon Services; Exhibit 2: Prior version of the Company's standard Service Contract with supporting exhibits and order forms for Authorization Services and/or Discount Coupon Services; and Exhibit 3: Standard customer billing invoices for Authorization Services and/or Discount Coupon Services rendered during a pilot and post-pilot period.
[13] 17 U.S.C. §§ 101 *et. seq.*
[14] See LR 10-007 for a full discussion of software licenses.

> connection with its use of Services. The Company reserves all rights not expressly granted to Client hereunder.

The above quoted language is indistinguishable from terms commonly used in other software licenses. Moreover, the sample copy of the most recent Service Contract, which was also submitted with Company's request, contains the same language as above, with the only change being the replacement of the term "license" with "right." (The same change was also made on the Discount Coupon Services Order Form.) Regardless of the terminology used, Company is granting a nonexclusive right to use the software--a taxable software license. The Company's monthly fee is subject to transaction privilege tax under the personal property rental classification.

Ruling:

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

1. Company's gross receipts derived from providing Merchandise Return Authorization Services are subject to Arizona transaction privilege tax unless such services amount to the creation of custom computer software and Company can show that it has separate lines of business in creating custom computer software and leasing software. However, only the gross receipts derived from the initial creation of the custom computer software, namely the Set Up/Implementation Services, are exempt from tax; any subsequent income derived from Authorization Services is subject to transaction privilege tax under the personal property rental classification as software licensing.

   Additional services provided in connection with the initial creation of any custom computer software are exempt from tax if separately stated on the invoice and in Company's books and records. However, any services provided in connection with the continued lease of the software on a monthly basis are subject to tax under the personal property rental classification regardless of whether or not they are separately stated.

2. Company's gross receipts derived from providing Discount Coupon Services are subject to Arizona transaction privilege tax in the same manner as its Merchandise Return Authorization Services as described above.

The conclusions in this taxpayer information ruling do not extend beyond the facts presented in your letters dated March 30 and April 23, 2010.

This response is a taxpayer information ruling (TIR) 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 information 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.

If the Department is provided with required taxpayer identifying information and taxpayer representative authorization before the proposed publication date (for a published TIR) or date specified by the Department (for an unpublished TIR), the TIR will be binding on the Department with respect to the taxpayer that requested the ruling. In addition, the ruling will apply only to transactions that occur or tax liabilities that accrue from and after the date the taxpayer receives the ruling. The ruling may not be relied upon, cited, or introduced into evidence in any proceeding by a taxpayer other than the taxpayer who has received the taxpayer information ruling. If the required information is not provided by the specified date, the taxpayer information ruling is non-binding for the purpose of abating interest, penalty or tax.