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Governor

## PRIVATE TAXPAYER RULING LR11-009

Gale Garriott  
Director

June 14, 2011

The Department issues this private taxpayer ruling in response to your request of February 26, 2009, as supplemented by your correspondence of April 8, May 5, and June 13, 2009, submitted on behalf of your client . . . ("Company"). You request a determination of the applicability of Arizona transaction privilege tax to Company's gross receipts derived from its business of administering "performance improvement programs" ("PIPs") on behalf of Arizona clients and program participants.

### Statement of Facts

The following facts are excerpted from your original February 26 request:

[Company] helps its clients (generally large corporations) achieve their business objectives by contracting with them to provide performance improvement programs that drive their strategic objectives such as revenue growth, market share improvement, brand loyalty or employee recognition. The programs typically include communication, training, measurement and awards directed at people who deliver incremental performance on business objectives. Incentive awards are in the form of points or codes printed on a card or paper certificate (hereinafter "points"). Participants, typically client employees, earn points by performing designated activities, achieving specific goals or exhibiting behavior that management wants to reinforce. Participants accumulate electronic points in a database account set up by [Company]. Participants can view balances and activity on their accounts via the Internet. These points may be redeemed for any of the many different awards featured in an awards catalog. Each award has a stated point value at which it can be ordered. The more points the participants accumulate during the program, the more awards he or she can earn at higher values.

[Company] bills the client for the program based on the services performed and points that are issued to the participants. [Company] invoices its clients on a per point basis which includes a certain amount of services such as program design and consultation, customer service, award shipment and applicable sales tax in addition to the award itself. Unique services that are client specific would be charged separately. About 20% of the awards are drop shipped from merchants across the United States. The balance of the merchandise is generally shipped from [Company]'s warehouses located outside the State of Arizona in [State A]. [Company]'s clients are located throughout the United States.

[Company] purchases the awards for resale from third party suppliers that may be located within or outside [State A]. [Company] purchases the items in its own name, not as agent for the client. The client does not take title to these items. When awards are ordered by a participant, [Company] ships them directly to the participant's home or other address as directed by the participant.

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Each participant has access to a catalog that details the amount of points necessary to obtain the merchandise. There is no dollar amount associated with points to the participant. Furthermore, no cash value is communicated to the participant relating to the value of the points. Finally, paying cash for an item or adding cash to their points is not an option under the program.

A sample agreement you provided for one client's "Peak Response" program contained the following terms:

Unless the parties otherwise agree in writing, the price for [Company's points], [Company]'s program management fee, and [Company]'s charges for mailing services and postage in the Statement(s) of Work will not exceed the amounts specified . . . .

. . . .

2.3 **MEDIA.** The Gallery Edition includes [Company]'s proprietary [point] reward media. The delivery platform for Customer's Program shall be specified in the Statement of Work and shall be either [point] Certificates, [point] Gold, or any [Company]-built electronic media platform . . . .

3. **[POINTS] PRICING & PAYMENT.** For each Customer [point] issuance request, [Company] will either deposit the Customer specified number of [points] into Participant personal accounts; or issue the specified amount of [points] on [point] certificates, as applicable, based upon Customer's [point] product selection. Customer agrees to pay [Company] \$28.00 per [point] issued to a participant or deposited into a personal account within the continental United States. [Point] pricing is in U.S. Currency. Customer understands that [points]' pricing includes the cost of merchandise, warehousing, merchandise shipping (within the continental United States only), and sales taxes. If applicable, Canadian GST, customs, duties, fees, and additional shipping charges are included in [points] merchandise being shipped to or on behalf of Participants in Canada. If applicable, Customer agrees to pay [Company] \$37.00 per [point] issued to a participant or deposited into a personal account within Canada. Customer agrees to make payment to [Customer] within ten (10) days from the date of each [Company] invoice (plus interest at the rate of 1.5% per month for past due payments).

4. **[POINTS] ISSUANCE.** [Points] reward media are issued to Participants either by (a) deposit into Participants' personal accounts, or (b) tender of [points] certificates to Participants (or by delivery to Customer on Participants' behalf) ("Issuance"). Upon Issuance, [points] are owned by the Participants and are non-refundable.

5. **[POINTS] REDEMPTION.** Participants redeem [points] for reward offerings included in the Gallery Edition of Peak Response as specified . . . . The issuance value of personal accounts or face value of [point] certificates are reduced by the amount of Participants' redemption. If determined in the best interests of

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Participants, [Company] may communicate with Participants or take such other action as may be deemed reasonably beneficial to encourage Participants' redemption of reward offerings. Upon termination or expiration of this Agreement or Customer's [points]' program, Participants with balances in personal accounts will have a period of no less than 150 days to redeem [point] balances. Thereafter, [points] balances in personal accounts with a minimum balance of at least one [point] will be entitled to receive [a points] certificate with a commensurate balance, less redemption.

Subsequent to the expiration of such 150 day redemption period, [Company] agrees to issue [point] Redemption Certificates in accordance with this Attachment. [Point] Redemption Certificates are personalized to the Participant based upon the balance contained in the Participant's account after the 150 day redemption period. The point certificate will be sent to the Participant at the last known address listed on the Participant's personal account. The Redemption Certificate is used by the Participant as a mail-in order form for redemption that occurs after the expiration of the 150 day period. The Redemption Certificate is different from the previous program earnings statements and includes mail-in order information. Customer, in conjunction with Customer's Participants, shall be responsible for providing updated Participant addresses. Each [points] Redemption Certificate is serialized with a unique reference number. Participants who use their Redemption Certificate to redeem their [points] earnings are required to redeem all remaining [points] in one order. Once the unique number on a Redemption Certificate is used, it is invalid for duplicate redemption attempts in the future.

6. **[POINTS]' RISK OF LOSS.** Like cash, [points]' certificates are a special bearer certificate that cannot be replaced if lost or stolen. . . .

Regarding transferability of points, one sample agreement entitled the "Showcase Edition Attachment to Peak Response System Agreement" provides the following:

Participants will be allowed to transfer [points] to another employee at the discretion of the participant, without limitation. They must complete the Account Transfer Authorization form and submit to the PIP Program Administrator for approval. The original recipient of the [points] will be responsible for tax liability of the [points].

In another sample agreement for a PIP entitled the "Ovation! Program," the following terms were provided regarding an "issuance bonus" Company provided to the customer:

(b) **ISSUANCE BONUS:** [Company] will provide [Customer] with an Issuance Bonus of 20,000 Points for each \$500,000 in Points invoiced and paid to [Company]. [Company] will maintain these bonus Points in a special account for [Customer] and will transfer Points out of the special account as directed by [Customer].

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In yet another agreement ("SA Master Service Agreement v.09.21.05"), a percentage-based rebate was provided to the customer:

[Company] will rebate to Customer 12% of the total [point] dollar value deposited. For example, if \$10,000,000 in [points] are deposited during the term of the Agreement, \$1,200,000 will be rebated back to Customer. The rebate may be used at the discretion of Customer's incentive department. Customer may use the earned rebate to fund contest communication tactics, purchase additional [points], or request it in the form of a check at any time. . . .

### Your Issues:

You raise the following issues, which have been paraphrased from your February 26 request:

1. Are the gross receipts derived from Company's sales of award codes or points (collectively "Points") as part of the PIPs it provides to its Arizona clients subject to Arizona transaction privilege tax?<sup>1</sup>
2. Is Company considered the consumer of tangible personal property shipped to Arizona participants?
3. If Company is liable for transaction privilege tax, what is the proper measure of tax: the cost of the merchandise redeemed or the point value charged to Company's clients?

### Your Positions

Your positions are as follows:

1. Company is not subject to transaction privilege tax on the gross receipts it derives from Points sales to Arizona clients. Points are intangible rights to future benefits and are valued as a combination of Company's services and the underlying tangible personal property sent to PIP participants in exchange for redeemed Points. The points do not hold any monetary value outside of the context of the PIPs and are essentially a means to measure the amount of future benefit a participant has accumulated or has left to use in a PIP.

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<sup>1</sup> Your February 26 request asks whether Company is liable for Arizona "sales tax" and argues that Company has "sales tax nexus in Arizona by virtue of its in-state employee." As stated in *Arizona General Tax Procedure* GTP 08-1, this office does not issue private taxpayer rulings on nexus. This private taxpayer ruling, however, will assume that Company has sufficient nexus with the state for the purposes of transaction privilege tax liability.

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2. Yes. Company is considered the final consumer of the tangible personal property shipped to Arizona participants and is liable for transaction privilege tax on such property under the retail classification.
3. The proper measure of Company's transaction privilege tax liability is the retail price to Company of the tangible personal property distributed to Arizona participants. The Company's "service component" for administering PIPs, the cost of which is bundled into the cost of Points to Company's clients, should be exempt from retail transaction privilege tax under Arizona Revised Statutes ("A.R.S.") § 42-5061(A)(2).

### Relevant Law

Pursuant to statute, Arizona levies transaction privilege tax under the retail classification on "the business of selling tangible personal property at retail," with the tax base encompassing the gross proceeds of sales or gross income derived from the business.<sup>2</sup> It is a tax on the privilege of engaging in business as measured by the gross income from all of its sales, rather than a tax on the sale of goods.<sup>3</sup>

A "sale" is statutorily defined 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 . . . .<sup>4</sup>

A sale "at retail" is one "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."<sup>5</sup> The burden of providing that a sale of tangible personal property is not a sale at retail is upon the seller, unless the purchaser has presented a properly executed resale certificate.<sup>6</sup> The tax base generally includes the business's gross receipts, which means

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<sup>2</sup> A.R.S. § 42-5061(A).

<sup>3</sup> *State Tax Comm'n v. Consumers Market, Inc.*, 87 Ariz. 376, 379, 351 P.2d 654, 655 (1960); see also *Duham v. State Tax Comm'n*, 65 Ariz. 268, 276-77, 179 P.2d 252, 257 (1947) (transaction privilege tax is measured by all of the business activity of a taxpayer rather than merely a part of it); *DaimlerChrysler Servs. N. Am., LLC v. Ariz. Dep't of Revenue*, 110 P.3d 1031, 1036 (Ariz. Ct. App. 2005) (citing *Arizona State Tax Commission v. Southwest Kenworth, Inc.*, 561 P.2d 757, 760 (Ariz. Ct. App. 1977)) (transaction privilege tax is imposed not on individual sales or transactions, but on the privilege of conducting business in the state, as measured by the gross receipts of the taxpayer derived from the business).

<sup>4</sup> A.R.S. § 42-5001(13).

<sup>5</sup> A.R.S. § 42-5061(V)(3).

<sup>6</sup> A.R.S. § 42-5022.

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the total amount of the sale, lease or rental price, as the case may be, of the retail sales of retailers, including any services that are a part of the sales, valued in money, whether received in money or otherwise, including all receipts, cash, credits and property of every kind or nature, and any amount for which credit is allowed by the seller to the purchaser without any deduction from the amount on account of the cost of the property sold, materials used, labor or service performed, interest paid, losses or any other expense. Gross receipts do not include cash discounts allowed and taken nor the sale price of property returned by customers if the full sale price is refunded either in cash or by credit.<sup>7</sup>

Although taxpayers 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 business, they cannot be taxed as a separate business."<sup>8</sup> Income from services that may be concededly nontaxable if carried on by a business that is not otherwise taxable under a tax classification may nevertheless be part of a taxpayer's gross receipts derived from business activities that are the basis of the taxpayer's principal activity.<sup>9</sup>

### Discussion

In reviewing the law and facts at issue, it is important to remember that Arizona transaction privilege tax is not a tax levied on isolated transactions, but is instead measured by all of the business activity of a taxpayer. As such, although certain sales might, in isolation, be viewed as nontaxable vis-à-vis the sixteen transaction privilege tax classifications, the gross receipts derived from such sales may nevertheless be taxable if the vendor is engaged in a taxable business and is unable to show that it engages in a separate, nontaxable line of business in making the sales.

To put this principle into context, the following three examples provide various common combinations of business activities undertaken with gift certificates, gift cards, or points (collectively "gift cards"):

1. If a business sells gift cards but does not engage in any other taxable business activities—for example, its only business activity is selling gift cards or it is otherwise solely engaged in a personal or professional service business—gross receipts derived from the gift card sales would not be subject to transaction privilege tax.
2. If a retail business sells gift cards for redemption by a business other than itself, its gross receipts from the gift card sales will generally be subject to tax, insofar as the retailer cannot show it is engaging in a separate, nontaxable line of business in selling the gift cards. A retailer's gift card sales are generally

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<sup>7</sup> A.R.S. § 42-5001(7).

<sup>8</sup> *Trico Elec. Coop., Inc. v. State Tax Comm'n*, 79 Ariz. 293, 297, 288 P.2d 782, 784 (1955).

<sup>9</sup> See *Walden Books Co. v. Ariz. Dep't of Revenue*, 198 Ariz. 584, 587-88, 12 P.3d 809, 812-13 (Ct. App. 2000).

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incidental to the business's retail activities and interwoven with the manner in which the business conducts its retail operation. As a result, the appropriate tax treatment is to include the income from the sales as part of the business's taxable retail gross receipts.

3. If a business sells gift cards that it will later redeem itself, regardless of whether redemption occurs at the same location of purchase, gross receipts from the sales of the gift cards will not be subject to tax, but the gross receipts from any sales occurring upon the redemption of the gift cards will be subject to tax.

### Ruling

Assuming that Company acts in good faith when it acquires the tangible personal property used as PIP awards as nontaxable sales for resale, Company appears to hold itself out as engaging in the business of selling at retail. Based on this conclusion and the facts provided, the Department rules as follows:

1. Company's gross receipts derived from Points sales are not subject to Arizona transaction privilege tax because it redeems Points that it sells itself.
2. Company is a retailer of the tangible personal property shipped to Arizona participants, not a consumer of them. In using a resale certificate when purchasing goods for use as PIP awards, Company is asserting that it intends to resell them. The transfer of tangible personal property in exchange for the Points as consideration, presented by a PIP participant for redemption with no purpose of resale, meets the statutory definition of a sale at retail.
3. Company is liable for transaction privilege tax, as measured by the Points value charged to Company's clients. The Points that PIP participants redeem with Company are a type of cash equivalent, property, or "amount for which credit is allowed" recognized by the statutory definition of gross receipts. As such, Company's retail transaction privilege tax liability must be measured by the value of the Points. There is no deduction or exemption for labor or service activities that are performed as part of Company's business operation.

This private taxpayer ruling does not extend beyond the facts presented in your correspondence and documentation of February 26, April 8, May 5, and June 13, 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**

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**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. In addition, this private taxpayer ruling only applies to transactions that occur or tax liabilities that accrue from and after the date the taxpayer receives the ruling.**

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