PRIVATE TAXPAYER RULING LR12-003

December 12, 2012

The Arizona Department of Revenue (the "Department") issues this private taxpayer ruling in response to your letter of September 10, 2012 ("Request") requesting a ruling for . . . ("Company") on behalf of . . . ("Subsidiary I") and . . . ("Subsidiary II") (Subsidiary I and Subsidiary II together, the "Subsidiaries"). Specifically, you request a ruling on the application of Arizona's transaction privilege tax ("TPT") to Subsidiaries' gross proceeds of sales or gross income derived from a mandatory student fee paid for each enrolled course ("Site Fee"). Pursuant to A.R.S. § 42-2101, the Department may issue private taxpayer rulings to taxpayers and potential taxpayers on request.

ISSUE:

Whether the Subsidiaries' gross proceeds of sales or gross income derived from the Site Fee is subject to Arizona's transaction privilege tax?

RULING:

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

Subsidiaries are engaged in the business of renting tangible personal property in the form of prewritten software and are subject to transaction privilege tax under the personal property rental classification on its gross proceeds of sales or gross income derived from the Site Fee collected from Arizona customers.

FACTS PROVIDED BY COMPANY:

The following are facts excerpted from the Request:

Background

Students that enroll in the Subsidiaries' online or on-campus educational programs are charged a tuition fee and a separate fee to access information, services and course materials ("Site Fee") through Subsidiaries' websites.

The Site Fee is a mandatory fee charged with each enrolled course. In some limited circumstances, the Site Fee is waived for promotional purposes, or where course materials are not required (*e.g.*, a student internship) or available electronically. In addition, the Site Fee will vary slightly in amount depending on the program the student is enrolled in (*e.g.*, associate's, bachelor's, or graduate degree program).

The [Subsidiary I] Site Fee covers access to [Subsidiary I's] learning management website that includes the following variety of resources and services, but not limited to:

- Application Service Provider ("ASP") computer simulation programs and virtual environments from third-party vendors, if part of a specific course. Students also may access virtual organizations (*e.g.*, computer labs) through [Subsidiary I's] website;
- Student tutorial services in math and writing through [Subsidiary I's] Centers for Math and Writing Excellence;
- Library content that enables students to access and research multiple database that contain reference sources and periodicals. [Subsidiary I's] "Ask a Librarian" services are available to students for research guidance and recommendations;
- Electronic textbooks and materials for the enrolled course and all courses offered by [Subsidiary I] (in some programs, only electronic textbooks for the enrolled course can be accessed). In general, students may view, download and/or print the electronic textbooks and course materials; and
- Course syllabus and required reading assignments.

For [Subsidiary II] these offerings are similar to the offerings provided by [Subsidiary I] but may be less extensive in certain situations. [Subsidiary II] students may opt out of the Site Fee and purchase their materials separately from an unrelated third-party supplier.

In both situations students are not required to download any software or install any hardware in order to access the information, resources and services available on the Subsidiaries' websites. Students access the website using their own computers and web browser software. In some limited instances, the Subsidiaries may provide students with software that must be downloaded and installed on the student's computer (*e.g.*, certain Information Technology courses require unique software). Students have the right to use such software during the period of time they are enrolled in the course only.

> The Site Fee is a single fee. The Subsidiaries do not separately itemize charges for the benefits received and have not charged transaction privilege tax on the Site Fee in Arizona.
>
> The Site Fees allow students access to a variety of information, services and course materials contained on a website.

The following are facts excerpted from the "[Subsidiary I] Terms and Conditions" which accompanied the Request:[1]

> These web site Terms and Conditions ("Terms of Use") apply to your access to, and use of, the University's web sites located at . . . as well as any other University-controlled sites, regardless of domain name or IP address (collectively "Site" or "Sites")…
>
> Please read these terms of use carefully as they contain important information regarding your legal rights, remedies and obligations. By accessing or using any of the Sites or the Services, you are entering into a legal contract with [Subsidiary I], the terms of which govern your use of the Sites. Accordingly, by your access or use you agree to be bound by the terms and conditions described herein and all additional terms incorporated by reference. If you do not agree to all of these terms, do not use the Sites or the Services.
>
> Copyright and Limited License from the University
>
> Unless otherwise indicated in the Sites, the Sites, the Services and all content and other materials on the Sites including, without limitation, the University logo, and all designs, text, graphics, pictures, information, data, software, routines, documentation, technology, sound files, other files, and the selection and arrangement therefore (collectively, the "Site Materials") are the proprietary property of [Subsidiary I] or their licensors or users and are protected by U.S. and international copyright and other laws. You are granted a limited license, without the right to sublicense, to access and use the Sites, the Site Materials and the Services, and to print hard copy portions of the Site Materials, for your educational, non-commercial and personal use only. Such license is subject to these Terms of Use, the applicable Additional Terms, if any and any other applicable terms and conditions, and without limiting any of the foregoing, you expressly agree not to:

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[1] The Department has elected to omit the facts from the "[Subsidiary II] Website Terms & Conditions" which also accompanied the Request because the terms of said agreement are virtually identical to the "[Subsidiary I] Terms and Conditions."

(a) Resell, lease, transfer, lend, timeshare, syndicate or commercially use the Sites, Site Materials or the Services;
(b) Decompile, reverse engineer, disassemble or otherwise attempt to derive any source code from the Sites, the Site Materials or the Services;
(c) Distribute, publicly perform or publicly display the Sites, the Site Materials or the Services;
(d) Modify, adapt, translate, or create any derivative works of the Sites, the Site Materials, the Services or any portion thereof;
(e) Use any data mining, crawlers, spiders, robots or similar data gathering or extraction methods;
(f) Download, index or in any non-transitory manner store or cache any portion of the Sites, the Site Materials, the Services or any information contained therein, except as expressly permitted on the Sites;
(g) Remove, deface, obscure, or alter any copyright, trademark or other proprietary rights notices affixed to or provided in connection with the Sites, the Site Materials or any Services;
(h) Create or attempt to create a substitute or similar service or product through the use of or access to the Sites, the Site Materials, the Services or any proprietary information related thereto; or
(i) Use the Sites, the Site Materials or the Services other than for its intended purposes.

Any use or attempted use of the Sites, the Site Materials or the Services other than as specifically authorized herein, without the express prior written permission of the University, or its licensors, is strictly prohibited and will, among other things, terminate the license granted herein. . . .

DISCUSSION & LEGAL ANALYSIS:

A. Software is tangible personal property.

A business that engages in the “selling of tangible personal property at retail” is subject to tax under the A.R.S. § 42-5061 retail classification. A business that engages in “leasing or renting tangible personal property for a consideration,” is subject to tax under the A.R.S. § 42-5071 personal property rental classification. In regard to whether software qualifies as tangible personal property, it is important to first understand what constitutes “tangible personal property." For the purposes of Arizona’s TPT and use tax, tangible personal property is much more than physical goods that a person can hold, touch, or feel. As defined in A.R.S. § 42-5001(16), it is property that “is in any other manner perceptible to the senses.”

Consistent with this definition, there is longstanding precedent in case law for applying a broad definition of tangible personal property to subjects other than physical goods such as

electricity, electronic delivery of software, and music played from a jukebox.[2] The Arizona Supreme Court addressed the scope of the taxation of tangible personal property in *State v. Jones*.[3] In *Jones*, the court held that when a person inserts a coin into a jukebox and listens to a phonograph record, he is purchasing tangible personal property.[4] The court stated that the playing of the record is perceptible to the sense of hearing and, hence, constitutes what the statute terms tangible personal property.[5] The current definition is not substantively different from that considered by the *Jones* court in 1943.

Pursuant to the facts provided by Company, Subsidiaries' gross proceeds of sales or gross income derived from the Site Fee include receipts for software. Similar to the broad definition of tangible personal property applied to the music heard in *Jones*, Arizona's expansive definition of tangible personal property includes software because software is property which may be seen, weighed, measured, felt or touched or is in any other manner perceptible to the senses. Therefore, Subsidiaries' gross proceeds of sales or gross income include receipts from tangible personal property.

B. Subsidiaries engage in the business of renting tangible personal property.

A determination must be made as to whether the gross proceeds of sales derived from a transaction which involves computer software, including remote access software arrangements, are properly classified under the retail classification at A.R.S. § 42-5061, the personal property rental classification at A.R.S. § 42-5071, or are otherwise exempt from Arizona TPT. The tax base for the retail classification is limited to the gross receipts derived from the business of selling tangible personal property "at retail."[6] However, the gross receipts from the rental or leasing of tangible personal property are subject to TPT under A.R.S. § 42-5071, unless a specific exemption applies.[7]

To determine whether a taxpayer is engaged in "selling," "leasing," or "renting" tangible personal property in the form of computer software, the Department first examines the relationship between the gross receipts derived from the transaction and the role of the software in the transaction as a whole. A transaction in which a taxpayer derives receipts from offering computer based services with software and where the receipts are related to the software are generally subject to TPT. Next, the Department reviews the rights that a taxpayer provides to its customer under the precise terms of the contractual agreement for the transaction at issue, including the duration of the customer's access to the underlying software and whether the taxpayer transfers a software license to its customers.

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[2] *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).
[3] *State v. Jones,* 60 Ariz. at 415, 137 P.2d at 971.
[4] *Id.*
[5] *Id.*
[6] A.R.S. § 42-5061(A).
[7] A.R.S. § 42-5071; A.A.C. R15-5-154(B).

A software license is dissimilar to arrangements that fall under the general "license" nomenclature used for leases and rentals of physical tangible personal property (*e.g.*, property that can be touched or felt). As discussed, 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.[8] Because of the interplay of federal copyright laws and the differences in the meaning of the terms "sale" and "license" as used in the federal Copyright Act,[9] compared to common law applications used in Arizona tax law cases,[10] a software license should not be confused with the common law concept of license. Tax treatment is based upon the rights that arise from a particular contractual arrangement.

A business is subject to TPT under the retail classification pursuant to A.R.S. § 42-5061 if the taxpayer grants a customer the right to the underlying product for a perpetual duration. A business is subject to TPT under the personal property rental classification pursuant to A.R.S. § 42-5071 if the contractual agreement has the effect of providing a customer, for a consideration, with the defined and exclusive right of use of the software for a specified period, the termination or conclusion of which necessitates the customer's return of the software to the vendor. If an agreement provides a customer with the exclusive right of use for a limited duration, the Department will find that the transfer of a software license demonstrates constructive possession by the customer.

If the transaction is classified under A.R.S. § 42-5071, A.A.C. R15-5-1502(A) provides, "the gross income derived from the rental of tangible personal property is included in the tax base under the personal property rental classification unless a specific statutory exemption, exclusion, or deduction applies." Note that, 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 corollaries exist for the personal property rental classification. A.A.C. R15-5-1502(D) enunciates this principle by stating, "[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."

Subsidiaries engage in the business of renting tangible personal property in the form of computer software based on the customer's limited duration of access to the software and

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[8] Frederick Chong & Gianpaolo Carraro, *Building Distributed Applications: Architecture Strategies for Catching the Long Tail*, MICROSOFT DEVELOPER NETWORK, Apr. 2006, http://msdn.microsoft.com; H. WARD CLASSEN, SOFTWARE LICENSING FOR LICENSEES AND LICENSORS 199-200 (3d ed. 2009).
[9] 17 U.S.C. § 101 et seq.
[10] *See, e.g.*, CLASSEN, *supra* note 11, at 19.

the transfer of a software license from Subsidiaries to said customer. In conformity with A.A.C. R15-5-1502, the Site Fee in its entirety is subject to TPT under A.R.S. § 42-5071.

C. Arizona TPT applies to all Site Fees collected from customers located in Arizona.

Subsidiaries have a physical presence in the State of Arizona and are taxable on all rentals of tangible personal property within Arizona. A.A.C. R-15-5-1503(D) states:

> Gross receipts from leasing or renting tangible personal property are not taxable if the property is shipped or delivered outside of the state and intended, at the inception of the lease, for use exclusively outside of the state.

The burden of proof for establishing the applicability of subsection (D) is on the lessor.[11]

For remote access software arrangements, the server location where the software and files are "physically" stored makes no difference for state TPT purposes; the location where the lessee uses the leased property on a non-temporary basis is what is determinative because the gross receipts from leasing or renting tangible personal property are not taxable pursuant to A.A.C. R15-5-1503(D) if the property is shipped or delivered outside the state and intended, at the inception of the lease, for use exclusively outside of the state. Therefore, a taxpayer's gross receipts derived from software leased to out-of-state lessees who use the software exclusively outside the state would be deductible.

This response is a private taxpayer ruling and the determinations herein are based solely on the facts provided in the Request. Therefore, the conclusions in this private taxpayer ruling do not extend beyond the facts presented in your correspondence dated September 10, 2012. 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 private taxpayer ruling shall be null and void. Further, the determination is subject to future change depending on changes in statutes, administrative rules, case law or notification of a different department position.

The determinations in this private taxpayer ruling are only applicable to the taxpayer requesting the ruling and may not be relied upon, cited nor introduced into evidence in any proceeding by a taxpayer other than the taxpayer who has received the private taxpayer ruling. 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.

[11] A.A.C. R15-5-1503(F).