STATE OF ARIZONA
Department of Revenue

Douglas A. Ducey
Governor

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Director

NOTICE OF MODIFICATION TO
PRIVATE TAXPAYER RULING LR13-006

March 23, 2016

Pursuant to Arizona Revised Statutes (A.R.S.) § 42-2101(C)(2), the Department is hereby giving you notice of this MODIFICATION to Private Taxpayer Ruling LR13-006 issued in response to your original letter to the Department dated February 25, 2013 requesting a ruling on behalf of ****. Specifically, you requested a ruling on the application of the Arizona Transaction Privilege Tax ("TPT") to ****'s gross proceeds of sales or gross income derived from certain of its business offerings, Business Offering One and Business Offering Two.

The Department issued Private Taxpayer Ruling LR 13-006 on June 25, 2013 and held that Business Offering One was taxable, but that Business Offering Two was not taxable because it did not satisfy the renting criteria. However, further analysis and research has made it necessary for the Department to revise its position in relation to Business Offering Two relating to cloud storage.

While the previous determination of exemption from tax for income derived from Business Offering Two is valid from the date of issuance of LR13-006 until the above date, any future income derived from Business Offering Two is subject to tax as of the receipt of this modification.

ISSUES:

To determine whether ****'s gross proceeds of sales or gross income derived from Business Offering Two relating to cloud storage is subject to Arizona's TPT the following issues must be considered:

1. Whether a cloud storage file is tangible personal property?

2. If a cloud storage file is tangible personal property, whether ****'s customers gain sufficient possession and control over it to constitute the rental of tangible personal property?

RULING:

A cloud storage file is tangible personal property. It uses encryption, a complex algorithm, forming a 'virtual container' to protect a customer's data by encoding it and thus keeping a customer's data secure. To the extent that these 'virtual containers' travel to and from data storage locations with the customer's data, they are considered tangible personal property.

The customers themselves have full control over their accounts and whether, when, and what data is uploaded or downloaded to ****'s servers. They also control who can upload and download data. In addition, they have the option to manipulate the remote storage more efficiently if they make use of the software development kit or the management console made available to them free of charge. Only the customer can decrypt its information through the use of its special 'key.' Finally, part of the customer's monthly fee is based on its activity while using the storage and this reinforces the fact that it is the customer who is in total control of the account and cloud storage file. As a result, the customer has sufficient control over the cloud storage files to constitute personal property rental. Business Offering Two is therefore taxable for Arizona TPT purposes.

SUMMARY OF FACTS:

All facts as presented in Private Taxpayer Ruling LR13-006 are incorporated herein by reference.

DISCUSSION AND LEGAL ANALYSIS:

Generally, in the case of cloud storage, a customer uploads its data or software to a business's servers via a web interface or some other means. Once uploaded, the data is encrypted [1] in secure files and then transported to the data's storage location. The encryption uses a complex algorithm to encode information and keeps the customer's data secure so that no one other than the customer or its authorized representative may have access to that data by use of a special 'key' which decrypts the encrypted data. The storage location may or may not be specified by the customer; and the data isn't necessarily stored on a specific server or even in a specific geographic location. Rather, it is stored in the most efficient manner determined by specific software configuration. When a customer requests its data be downloaded or accessed, the customer's data is transported from its storage location on a server and to the customer's local machine. At that time the data is decrypted so that it is readable by the customer when it is retrieved.

[1] See generally http://computer.howstuffworks.com/cloud-computing/cloud-storage.htm

One of the biggest concerns for data storage is data security; encryption as well as authorization (listing of delegates) and authentication (usernames and passwords) are normally used by cloud storage providers.

The remote storage offered by **** is no different. Customers can store and retrieve large amounts of data from ****'s network at any time and from any location via the Internet by setting up an account which is presumably password protected. Thus, only the customers or its authorized users may upload, download or otherwise access its data on the ****'s servers. The remote storage is scalable so that customers can increase their storage needs as they evolve. Customers have the option of using *free* software development kits and a management console that allow them to make more efficient use of the storage. **** charges a fee based on the amount of gigabytes used in a given month and a usage fee based on a customer's monthly activity on its servers. Customers that utilize the storage retain ownership of their uploaded data.

Whether a cloud storage file is tangible personal property?

Arizona Revised Statutes ("A.R.S.") § 42 5001(17) 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. Consistent with that broad definition of tangible personal property there is longstanding precedent in case law for that definition to be applied to things other than physical goods, such as electricity, electronic delivery of software, and music played from a jukebox.[2] Significantly, in applying the broad definition of tangible personal property, numerous courts have concluded that software is tangible personal property and subject to tax.[3] In *Wal–Mart Stores, Inc. v. City of Mobile*,[4] for example, the court held software was tangible personal property; it is an arrangement of matter that makes a computer perform a desired function and is physically recorded on some tangible medium, making it tangible personal property. In the case of cloud data storage, the data is stored in encrypted files on servers. A taxpayer provides the encrypted

[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] See, e.g., *Comshare, Inc. v. United States*, 27 F.3d 1142 (6th Cir.1994) (income tax credit); *Wal–Mart Stores, Inc. v. City of Mobile*, 696 So.2d 290 (Ala.1996) (sales tax); *Andrew Jergens Co. v. Wilkins*, 109 Ohio St.3d 396, 848 N.E.2d 499 (2006) (property tax); Ruhama Dankner Goldman, Comment, From Gaius to Gates: Can Civilian Concepts Survive the Age of Technology?, 42 Loy. L.Rev. 147, 158 (1996) ("the trend in classification of computer software has been to classify it as tangible personal property").
[4] 696 So.2d 290 (Ala.1996).

files that encode data using a complex algorithm which forms a 'virtual container' for its customer's data so they may store their data securely. Only the customer has access to the data and has the ability to decrypt the code. To the extent these 'virtual containers' travel to and from data storage locations and in doing so secure the customer's data through the use of encryption, they are considered tangible personal property.

Whether ****'s customers gain sufficient possession and control over the cloud storage file to constitute the rental of tangible personal property?

A.R.S. § 42-5071 imposes the TPT on the business of leasing or renting tangible personal property for a consideration.[5] The tax base for the personal property rental classification is the gross proceeds of sales or gross income derived from the business.

The Arizona Supreme Court in *State Tax Commission v. Peck*[6] set out guidelines for determining whether a particular activity is considered personal property rental. Peck considered whether the business of coin-operated self-service laundries and car washes constituted leasing or renting tangible personal property for a consideration. To resolve this issue, the *Peck* court adopted a dictionary definition of the verb "to rent". It noted:

> Webster's Third International Dictionary defines the verb "to rent" as "(1) to take and hold under an agreement to pay rent," or "(2) to obtain the possession and use of a place or article for rent.[7]

The court determined that:

> There is no question that when customers use the equipment on the premises of the plaintiffs herein, such customers have an exclusive use of the equipment for a fixed period of time and for payment of a fixed amount of money. It is also true that the customers themselves exclusively control all manual operations necessary to run the machines. In our view such exclusive use and control comes within the meaning of the term "renting" as used in the statute.[8]

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[5] Because storage fees are paid on a monthly basis, the personal property rental classification is appropriate in this case. The retail classification would be relevant in a situation where customers pay a one-time fee without any renewals and get complete access to the remote storage on a perpetual basis.
[6] 106 Ariz. 394, 476 P.2d 849.
[7] *Id*. at 396, 476 P.2d at 851.
[8] *Id.*

The case of *Energy Squared v. Arizona Department of Revenue*[9] may be contrasted with the *Peck* case. The court there rejected that the business of operating tanning salons amounted to renting tanning beds and booths under the personal property rental classification. Rather, it held that the taxpayers were rendering personal services through the use of equipment that remained effectively theirs. This was because there was significant participation in and control over the delivery if the UV exposure by the taxpayer business such that the requisite control over the tanning device by the customers required for the personal property rental classification was absent. Essentially, in *Peck* the customers themselves solely used the machines while, in *Energy Squared*, the taxpayer business used the machines to perform a customized service for its customers.

Significantly here, there is no customization or professional service provided by **** to its customers. The customers themselves have full control over their accounts through the use of a username and password; and they decide and whether, when and what data is uploaded or downloaded. In doing so, they control the encryption and decryption of their data. In addition, they have the option to manipulate the remote storage more efficiently if they make use of the software development kit or the management console made available to them free of charge. Finally, part of the customer's monthly fee is based on its activity while using the storage and this reinforces the fact that it is the customer who is in total control of the account and cloud storage file. As a result, the customer has sufficient control over the cloud storage files to constitute personal property rental. Thus, Business Offering Two in the form of remote storage is taxable for Arizona TPT purposes.

Presumably, any services performed by **** are only required when a customer has issues with the functioning of the remote storage. Thus, any personal services provided is minimal, at best, and would not rise to the level contemplated by *Energy Squared*.

For remote rental arrangements, it is the location where a user uses the software or other files that is essential and not the location where a server is located. As such, ****'s gross income derived from the rental of tangible personal property in the form of cloud storage files is taxable when received from Arizona customers.

The taxability determinations provided by LR13-006 as a MODIFICATION to Private Taxpayer Ruling LR13-006 issued on behalf of your client, do not extend beyond the facts presented in your original correspondence dated February 25, 2013 and save and except for the additions or changes noted herein, Private Taxpayer Ruling LR13-006 issued by the Department on June 25, 2013 remains in full force and effect.

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[9] 56 P.3d 686, 203 Ariz. 507.

This modification to private taxpayer ruling LR13-006 and the determinations herein are based solely on the facts provided in your request and subsequent correspondence. 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 modification to Private Taxpayer Ruling LR13-006 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 private taxpayer ruling LR13-006 and this modification 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 modification to LR13-006 only applies to transactions that occur or tax liabilities that accrue from and after the date shown above.

Lrulings/13-006-D MOD

PRIVATE TAXPAYER RULING LR13-006

June 25, 2013

The Department issues this private taxpayer ruling in response to your letters ("Request") requesting a ruling on behalf of . . . ("Company"). Specifically, you request a ruling on the application of the Arizona Transaction Privilege Tax ("TPT") to Company's gross proceeds of sales or gross income derived from . . . ("Business Offering One") and . . . ("Business Offering Two"). Pursuant to Arizona Revised Statutes ("A.R.S.") § 42-2101, the Department may issue private taxpayer rulings to taxpayers and potential taxpayers on request.

ISSUE:

Whether the Company's gross proceeds of sales or gross income derived from Business Offering One and Business Offering Two are subject to Arizona's transaction privilege tax?

RULING:

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

The business activities of Company in Business Offering One satisfy the renting criteria. Company is engaged in the business of renting tangible personal property and is subject to TPT under the personal property rental classification on its gross proceeds of sales or gross income derived from Arizona customers for its Business Offering One.

The business activities of Company in Business Offering Two do not satisfy the renting criteria. Additionally, Business Offering Two is not subject to tax under the remaining TPT classifications. Therefore, Company's gross receipts derived from Business Offering Two are nontaxable. However, because Company engages in the rental of tangible personal property for purposes of Business Offering One, Company must demonstrate that its Business Offering Two business activities exist as a separate line or lines of business in order to be excluded from its taxable gross receipts.

FACTS ASSERTED BY COMPANY:

The following are facts excerpted from your February 25, 2013 and May 8, 2013 letters:

Business Offering One's core benefit is that it allows customers to obtain computing capacity and control their computing resources without a significant information technology investment (*e.g.*, customers no longer have to buy their own servers or set-up their own on-premises data centers). In order to use Business Offering One, customers request a configuration of memory, CPU, storage, and operating system ("OS"). This configuration is called an "X" and is the basis for the fee the customer is charged for Business Offering One usage. An X is similar to accessing the computing power of a personal computer with a similar configuration of memory, CPU, storage, and OS. Customers are not required to use specific software to use Business Offering One, but some basic OS is required to direct the computing power; therefore, an OS is provided with each X. In all cases, Company procures the OS software for its own use in data centers and provides customers with access to the OS. A customer may prefer access to one OS over another, which is why they are given a choice. Customers can use the OS to upload the applications they wish to run using Company's computing power and can use the application programming interfaces to allow their existing systems to communicate to the Business Offering One service. Specifically, Company makes available either open source or third-party OS software with each X so that the customers can make use of the virtual servers.

Business Offering Two allows customers to store, retrieve, and maintain content, data, applications, and software on its servers. Customers that utilize Business Offering Two retain ownership of their content uploaded to the Company network. Company does not have the authority to use, sell, or license customer content being stored within Business Offering Two. Company provides access to the infrastructure necessary for customers to store their own digital content. The management console allows users to create Business Offering Two . . . (*i.e.*, essentially a file folder) and then upload or delete objects. The tools are optional; customers may choose to make use of Business Offering Two without utilizing these tools. Customers are charged both a base fee, determined by the amount of gigabytes used in a given month, as well as an incidental usage fee based on their activity while using Business Offering Two. The flat fee prices are on a sliding scale, per gigabyte basis. The usage fee is called a "Fee." Fee is based upon a customer's activity on the Company's network, such as when a customer requests access to resources in a new data center or requests that data be copied or moved within the network.

DISCUSSION & LEGAL ANALYSIS:

A.R.S. § 42-5071 taxes the business of leasing or renting tangible personal property for a consideration. The term "renting" is not specifically defined in statute by the Arizona Legislature. For undefined terms, as a general rule of construction, courts consult an established and widely used dictionary to determine their common and ordinary meaning. *See*, *e.g.*, *United Dairymen of Ariz. v. Rawlings*, 217 Ariz. 592, 596, 177 P.3d 334, 338 (Ct. App. 2008). In *State Tax Comm'n v. Peck*, *State Tax Comm'n v. Peck*, 106 Ariz. 394, 476 P.2d 849 (1970), the Arizona Supreme Court defines the verb "to rent" as "to obtain possession and use of a place or article for rent." *Id*. at 396, 476 P.2d at 851. The court added that "[i]n our view, . . . exclusive use and control comes within the meaning of the term 'renting' as used in the statute." *Id*. In *Energy Squared, Inc. v. Arizona Department of Revenue*, 56 P.3d 686 (Ariz. Ct. App. 2002), the Court of Appeals reaffirmed that the imposition of TPT upon a personal property lease or rental "hinges on the degree of control over the property in question that is ceded to its putative 'lessee' or 'renter.'" *Id.* at 689.

Business Offering One involves the renting of tangible personal property under A.R.S. § 42-5071. The questions of whether a Business Offering One X may be commenced at all and the question of how long the Business Offering One X may last, are under the exclusive control of Company's Business Offering One customers. Business Offering One customers determine when a Business Offering One X can commence because the Business Offering One customers do not have to rely on Business Offering One's technician to assess the customers' conditions, determine which architecture of the virtual machine is best, advise the customers about whether their goals can be met, and which

equipment is most likely to achieve it. Additionally, Business Offering One customers decide how long the Business Offering One X may last because the customers start the X at the specific point in time they desire and may terminate it at any moment. The question of which X is appropriate is also significantly within the customers' control. The Business Offering One customers know what they want and how much of it they want, and need no help in using the available equipment to get it. Business Offering One customers do not have to rely on a Business Offering One technician's assessment to determine what kind of X may be used. Therefore, Company is engaged in the business of renting tangible personal property. The fact that the Business Offering One infrastructure is located on Company's premises does not prevent Business Offering One's customers from obtaining the requisite degree of control or possession.

The business activities of Company in Business Offering Two do not meet the criteria under A.R.S. § 42-5071 for the renting of tangible personal property. Business Offering Two provides storage capacity only and does not involve the right to control or possess software or other tangible personal property. Moreover, Business Offering Two is not subject to tax under the remaining TPT classifications. Instead, the Business Offering Two offering amounts to a nontaxable service.

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 February 25, 2013 and May 8, 2013. 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.