STATE OF ARIZONA
Department of Revenue

Douglas A. Ducey
Governor

David Raber
Director

PRIVATE TAXPAYER RULING LR15-001

February 24, 2015

Thank you for your letter dated December 17, 2013 requesting a revised private taxpayer ruling on behalf of ***, Inc. ("***"). Specifically, you requested a revised ruling regarding the applicability of the Arizona transaction privilege tax ("TPT") and use tax to ***'s cloud computing business. Pursuant to Arizona Revised Statutes (A.R.S.) §42-2101(C), the Department may revoke or modify a private taxpayer ruling requested by taxpayers and potential taxpayers. Accordingly, the Department hereby revokes Private Taxpayer Ruling LR13-002.

ISSUE:

To determine whether ***'s gross receipts derived from the business of computer backup and restoration is subject to Arizona's TPT the following issue must be addressed:

> Whether ***'s customers gain control and possession of its software sufficient to constitute the rental of personal property or whether *** is rendering personal services through the use of software that remains effectively within its own control.

RULING:

> Both pieces of software used by *** in its backup systems (the Services Software and the Agent) must be considered together since neither can operate in the absence of the other. They function together as a single unit to deliver the backup, retrieval and storage functions. ***'s customers are given access to the *** website through the use of a unique username and password, and are able to view their previously backed up files, request which files should be backed up and request the retrieval of data and files. As such, they use ***'s backup system similarly to the way they would use a backup system installed on their local network. As a result, they gain control and possession of the software sufficient to constitute rental of personal property, albeit remotely. Therefore *** is liable for TPT taxes on the sale of its subscription services to customers in Arizona.

***'s employees do not perform any services for its customers other than customer support. Therefore, the question of whether personal services are being rendered through software does not arise.

SUMMARY OF FACTS:

The following is a summary of the relevant facts based on your letter dated December 17, 2013 together with its enclosures and subsequent correspondence with the Department:

***, a *** corporation, is engaged in the business of providing cloud computing that uses software to backup, store and retrieve its customers' content and data on its network in return for a subscription fee. It's customers are located throughout the United States, including ***. ***. ***. However, it has operated its business in the United States since ***.

Customers that subscribe to ***'s cloud computing business retain ownership of their content on ***'s network. *** does not have the authority to use, sell, or license customer content being stored within its network. ***'s business benefits its customers by allowing them to obtain *** resources without a significant technology investment.

***'s engineers have developed software ("Service Software") that performs the function of backing up, retrieving and storing content and data on ***'s network. In developing the Service Software, *** may utilize open source software technology. The Service Software performs the backup, retrieval and storage functions by pre-written programming of a series of commands. It is programmed to perform backups on a predetermined schedule based on a multitude of factors, including *** among others. The Service Software performs those functions without being directly prompted by a user.

*** maintains direct possession and control over the Service Software which is not transferred to or downloaded by its customers. Its customers do not have a license to the Service Software. Logging into ***'s network or website is not a requirement for, and has no effect on, the utility of the Service Software.

***'s customers agree to certain terms of service ("Terms of Service"), an agreement between *** and its customers that set forth customer privacy policies and certain permitted and unpermitted uses of the service. ***'s terms of Service include a limited, non-transferable, non-exclusive license to customers to access ***'s website and download an agent ("Agent"), a piece of interface software, that serves primarily to establish a

connection between the customer and the Service Software in order for the Service Software to perform its backup, storage and restoration functions. By itself, the Agent does not have any independent functionality or utility outside the connection it establishes. The Agent must at all times be connected with both the customer's computer and the Service Software so that the Service Software may perform its functions. Neither the Service Software nor the Agent can function without a paid subscription.

The Agent is available to anyone who creates an account, paid or unpaid. It is provided free of charge and there is no monetary value assigned to the Agent. Neither is it billed for separately on any invoice. However, it is completely ineffective and cannot function without a subscription. *** is able to update the Agent at any time.

***'s customers may utilize its website for the purpose of obtaining information about *** and its products. Customers can also access their previously backed up files by logging into their *** account with their unique username and password. In its Terms of Service, ***'s customers agree to keep their account information secret so as to prevent unauthorized access to it. No software is required to access the website or access stored files. Once logged in, customers may view their files, request restoration of data and files and specify which files or data it would like backed up.

If a customer decides not to continue a subscription with ***, its files are deleted from ***'s servers.

***'s employees do not perform any services for its customers other than customer support.

DISCUSSION & LEGAL ANALYSIS:

*** offers software that performs backup, storage and retrieval functions for its customers. ***'s customers are charged an *** subscription fee to be able to get the benefit of the software's functions. Whether ***'s gross income derived from its subscription fee is taxable for TPT purposes is dependent on whether that fee is primarily derived from the rental of tangible personal property or from personal services.

Consistent with the broad definition of tangible personal property as provided in A.R.S. § 42-5001(16), there is longstanding precedent in case law for that definition to be applied to subjects other than physical goods, such as electricity, electronic delivery of software,

and music played from a jukebox.[1] The Arizona Supreme Court's decision in *State v. Jones*[2] addressed the scope of the taxation of tangible personal property. There, it held that when a person inserts a coin into a jukebox and listens to a phonograph record, he is purchasing tangible personal property; the playing of the record is perceptible to the sense of hearing and, hence, constitutes tangible personal property under the statute.

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] the issue was whether computer software was intangible personal property. In coming to the conclusion that software was, in fact, tangible personal property, the court noted:[5]

> The software itself, i.e., the physical copy, is not merely a right or an idea to be comprehended by the understanding. The purchaser of the computer software neither desires nor receives mere knowledge, but rather receives a certain arrangement of matter that will make his or her computer perform a desired function. This arrangement of matter, physically recorded on some tangible medium, constitutes a corporeal body.

Because software is normally recorded on some physical medium, whether it is located remotely on servers, downloaded on to a local network or delivered as hardware, it is tangible personal property. Therefore, software is generally accepted to be tangible personal property, and in this case, the Agent and Software Services are tangible personal property for TPT purposes.

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[1] *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).

[2] *Jones*, 60 Ariz. at 415, 137 P.2d at 971.

[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)

[5] *Walmart,* 696 So. 2d at 291, citing *South Cent. Bell Tel. Co. v. Barthelemy*, 643 So.2d 1240, 1244–45 (La.1994).

A.R.S. § 42-5071 imposes the TPT on the business of leasing or renting tangible personal property for a consideration. The tax base for the personal property rental classification is the gross proceeds of sales or gross income derived from the business. The personal property rental classification includes all fees and charges associated with the rental of tangible personal property and is not limited to only those charges identified as "rent." In this regard, the Arizona Administrative Code ("A.A.C.") R15-5-1502(D) specifically provides that:

> Gross 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.

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.
> …
> The operation of the plaintiff's businesses is characterized by the lack of personal services provided by the owner.[8]

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[6] 106 Ariz. 394, 476 P.2d 849
[7] *Id*. at 396, 476 P.2d at 851.

In the case of *Energy Squared v. Arizona Department of Revenue*,[9] the court had to determine whether the business of operating tanning salons amounted to renting tanning beds and booths under the personal property rental classification. As a result of strict federal tanning regulations, the taxpayer in that case employed technicians whose jobs were to determine the kind and amount of UV exposure permitted to each customer on each visit, and generally to supervise the visits. In agreeing that the taxpayers were rendering personal services through the use of equipment that remained effectively theirs, the Court noted:

> The taxpayer's customers do not "themselves exclusively control all manual operations necessary to run" the tanning beds or booths in question. They may select within a five-minute window when the tanning session begins and may terminate it early. By design, however, the question whether a tanning session may be commenced at all, and the question of how long the tanning session may last, are in the exclusive control of the taxpayer's tanning technician. The question of which particular tanning device is appropriate is also significantly within the technician's control. In sum, the "exclusive use and control" by the customer that *Peck* determined to be the essence of "renting" within the taxing statute is not present here.[10]

Essentially, the difference between *Peck* and *Energy* squared was the fact that there was significant participation in and control over the delivery of UV exposure such that the requisite control over the tanning device by customers was absent. The Court noted:

> Unlike the owners of coin-operated, self-service laundries and car washes, the taxpayer customizes each of its patrons' use of UV-radiation-generating devices to maximize customer safety and optimize tanning results according to the customer's wishes. It is true that the owner of a coin-operated, self-service laundry or car wash may have the raw power to interrupt its customer's use of its equipment. In the instant case, however, the taxpayer reserves overall control over its customers' use of tanning devices not merely by virtue of its control over its premises, but

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[8] *Id.*
[9] 56 P.3d 686, 203 Ariz. 507
[10] *Id.* at 689; 203 Ariz. at 510.

> rather as a part of the business design by which it provides artificial tanning.[11]

The pivotal question, then, is whether ***'s customers gain sufficient control and use of any of its software to constitute the rental of tangible personal property. Since both the Agent and the Service Software cannot function independently of each other, and because neither is offered or charged for separately, in examining the use of software, both must be examined together. The granting or non-granting of a software license is not definitive of that question because a software license is dissimilar to other arrangements that fall under the general license nomenclature used for leases and rentals of tangible personal property. Virtually all sales of prewritten software are sales of nonexclusive rights to use, regardless of whether the software is sold on physical media or transmitted electronically or whether they have perpetual or limited terms. In addition, whether a customer is able to download not definitive. The *Peck* Court noted:

> We do not believe that the terms "leasing" or renting as used in the statute require that property so leased or rented be physically capable of being transported from one place to another by a customer. Nor do we believe that the mere attachment of a label such as "license" borrowed from other areas of law, can be dispositive of the tax question before us.[12]

As noted in *Peck*, actual possession of the property is not essential for a finding of control. Constructive possession is sufficient. Constructive possession may be established through a level of use that establishes the user's possession of the software.

Manipulation of software can establish its constructive possession. Manipulation of software does not require that a user have access to its source code or the ability to change it. However, the type of manipulation required depends on the type of software involved. For example, word processing software would require a user to manipulate it by typing; database software is manipulated by requiring a user to enter their search parameters. Antivirus software, however, is used merely by installing; the software performs all the necessary functions.

Backup systems have evolved tremendously over the last decade from the use of internal backup systems (e.g. preinstalled software that updates on a regular basis without user

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[11] *Id*. at 690; 203 Ariz. at 511
[12] *Peck*, 106 Ariz. at 396; 476 P.2d at 851.

intervention),[13] to external backups in the form of storage disks and CD ROMs (required someone to save data and files to the external media), to the more recent remote or cloud backup systems. Internal backup systems function automatically in accordance with a schedule which may be set by the user. Internal backup systems also normally have the ability to perform incremental backups where the software detects changes made since the last backup was performed. It additionally allows the user to determine which files should be saved. External backups, on the other hand, requires more user involvement in that it requires the user to save data to some external media. External backups do not usually involve the use of software, only storage space is required.

*** provides cloud computing backup through software that backs up, stores and retrieves its customers' content and data on its network in return for a subscription fee. The business is designed so that the customer downloads Agent which establishes a connection with Service Software. The customer then pays a subscription fee to activate the Service Software so that it can perform its functions. The connection between the customer and the Service Software, made possible by the Agent, allows for data transfer between the customer and the Service Software which is done automatically without any prompting. This enables the Service Software to back-up a customer's files and store its data on ***'s network. ***'s customers have access to ***'s website at anytime from anywhere. Its customers access the website by the use of a unique username and password, and once a customer logs into their account, they can:

- Request the retrieval of lost data,
- Specify which files should be backed up, and
- View previously backed up files.

***'s employees do not perform any of these activities. They may assist a customer with customer support, if required, but do not ordinarily perform any other personal services for the customers.

The question is whether those activities amount to manipulation of software sufficient to constitute control of the software involved, or whether only personal services are performed through the use of software. While the retail classification provides for a deduction from gross income where personal services are performed and where tangible personal property is involved only as an inconsequential element, there is no similar deduction under the personal property rental classification. Under the personal property classification, the focus is on whether and how the customer uses the tangible personal property.

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[13] An example of this type of software includes the Apple's Time Machine which comes pre-installed on some Apple Computers.

Peck rejected the argument that there were any personal services involved in that case noting that "indeed the operation of plaintiff's business is characterized by the lack of personal services provided by the owner."[14] On the other hand, in *Energy Squared* the court found that the taxpayer used tangible personal property as a tool to perform the desired service in the same manner that a dentist or hairdresser may use tools in their trade. In *Energy Squared*, the technicians customized each customer's tanning experience and determined whether and the type and amount of UV exposure each customer could receive. Significantly, there is no such customization here. *** has specifically indicated that there are no personal services performed by its employees other than customer support. And presumably, those services are only required when a customer has issues with the functioning of its software. Thus, any personal services provided is minimal, at best, and would not qualify to support an argument that *** is providing personal services through the use of software.

An examination of the way traditional backup software is used reveals that internal backup software installed on a machine normally operates on a predetermined schedule where the schedule may be determined by the user. A user may also designate which files and data should be backed up. ***'s cloud backup system offers similar functions to its customer, albeit, remotely. Its software backs up a customer's files and data on a predetermined schedule but it gives the user the additional option to determine which files should be backed up, to view files already backed up and to request retrieval of certain files or data. Additionally, *** gives its customers exclusive online access to its website through the use of a unique customer created username and password so that they have the option of utilizing those functions.

***'s backup system does not give its customers any less usage than they would have had had they utilized a backup system on their local network. Rather, the benefit of ***'s backup system is that it allows normal backup functions at a fraction of the cost because *** provides the necessary infrastructure. Therefore, ***'s customers manipulate its software so that it has possession and control within the meaning of the personal property rental classification. As such, ***'s gross receipts are derived from the rental of tangible personal property in the form of software and such receipts are therefore taxable when received from Arizona customers.

This response is a private taxpayer ruling and the determinations herein are based solely on the facts provided in your request. Therefore, the conclusions in this private taxpayer ruling do not extend beyond the facts presented in your

[14] *Peck*, 106 Ariz. at 396, 476 P.2d at 851

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 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.

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