STATE OF ARIZONA
Department of Revenue

Douglas A. Ducey
Governor

David Briant
Director

TAXPAYER INFORMATION RULING LR 17-001

January 3, 2017

Thank you for your firm's letter dated September 17, 2015 requesting a taxpayer information ruling on behalf of your undisclosed client, ("Taxpayer"). Specifically, you requested a ruling regarding the applicability of the Arizona transaction privilege tax ("TPT") to your Client's various web-based *** solutions. Pursuant to Arizona Revised Statutes (A.R.S.) § 42-2101, the Department may issue taxpayer information rulings to taxpayers and potential taxpayers on request.

ISSUES:

1. Are receipts from Offering 1 customers who are invoiced at a single Arizona business address subject to TPT when Offering 1 programs and applications are hosted outside the state and used by customers to search online *** system for *** based on the user's own established *** specifications and *** policies?
2. Are receipts from Offering 2 customers who are invoiced at a single Arizona business address subject to TPT when the Offering 2 application is hosted outside the state and the customers do not have the ability to directly access or configure the Offering 2 application?
3. Are receipts from Offering 3 customers who are invoiced at a single Arizona business address subject to TPT when the Offering 3 application is hosted outside the state and remotely accessed by the customers to configure automated tasks and create specific tasks within the Offering 3 task management tool?
4. Are receipts from Offering 4 customers who are invoiced at a single Arizona business address subject to TPT when the Offering 4 application is hosted outside the state and remotely accessed by the customers to configure the online data management tools and generate various performance reports?
5. To the extent any of the Offerings are determined to be subject to Arizona TPT as a taxable lease or rental of tangible personal property, would the amounts derived from licensed users located outside the state be included in the tax base when the customer is invoiced in Arizona and also has licensed users in the state?

RULING:

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

Customers gain sufficient control and possession of the software offerings from Taxpayer to constitute constructive possession. At each level, the customer is able to customize what it needs based on its level of sophistication by manipulating the software. Therefore, taxpayer's customers manipulate its software so that they have the requisite possession and control to constitute a rental within the meaning of the personal property rental classification. Thus, the monthly gross receipts or gross income Taxpayer receives from its customers under Offerings 1, 2, 3, and 4 are taxable under the personal property rental classification when those monthly gross receipts are received from Arizona customers.

Additionally, Taxpayer's tax base includes all other fees and charges associated with the rental of tangible personal property. In addition to fees collected under Offerings 1, 2, 3 and 4, the following fees collected by Taxpayer are also included in its tax base under the personal property rental classification:

- Transaction Fees under Offering 1
- Implementation Fees under Offering 1
- Marketing Fee under Offering 1
- Distributor Fee under Offering 1
- Transaction Fees under Offering 2
- Access Fee under Offering 3
- Implementation Fees under Offering 4
- Historical Data Transaction Load Fee under Offering 4
- Proprietary Interface Design Fee under Offering 4
- Consulting Services Fees under Offering 4
- Consulting Fees under Offering 4

Arizona Revised Statutes (A.R.S.) § 42-5040.C provides that gross receipts from leasing or renting tangible personal property shall be sourced to either the lessor's business location if the lessor has a business location in this state or to the lessee's address if the lessor does not have a business location in this state. The gross receipts are taxable when the property is shipped, delivered or otherwise brought into this state for use in this state. See also Arizona Administrative Code (A.A.C.) rule R15-5-1503.

FACTS ASSERTED BY COMPANY:

Taxpayer is a corporation headquartered outside Arizona. The Taxpayer specializes in integrated web-based *** solutions. Specifically, the Taxpayer's four main offerings include the following: Offering 1, Offering 2, Offering 3, and Offering 4 (collectively referred to as the "Offerings").

The Taxpayer maintains no office locations in Arizona but does maintain some home-office employees in the state. The Taxpayer's customers are ***, located both within and without Arizona. In general, *** purchase Taxpayer's Offerings to enhance their existing online *** process and services. In some instances, the Taxpayer's customers will use the Taxpayer's Offerings at different offices located in various states. In other instances, customers will actually purchase the Taxpayer's Offerings to then resell or relicense to the *** own customers (i.e. individual ***), also located within and without Arizona. The Taxpayer generally uses a customer's single business address to invoice customers for the four Offerings, even if the customer uses the Taxpayer's Offerings at multiple locations. The Taxpayer may provide all four Offerings to the same customer or may also provide each of the four Offerings separately.

Offering 1 Overview

Offering 1 is an online *** tool used by *** to ensure that *** comply with a company's specific *** policies. Offering 1 customers are able to remotely access the Offering 1 programs and applications and configure various rules and policies. The Offering 1 application is embedded in ***'s existing online *** system, which is ***.

When purchasing Offering 1 from the Taxpayer, *** are granted the right to redistribute, sublicense, rebrand, and resell Offering 1 to their own corporate customers. Companies purchase the rebranded Offering 1 from ***, authorizing a company's individual employees to directly *** through the ***'s existing *** system. The Offering 1 application is configured to ensure that *** comply with *** policies. Examples of such ***. Fees for Offering 1 are based on both fixed annual fees (e.g. implementation fees) and separate transactional fees (*** using Offering 1).

Offering 2 Overview

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Offering 2 is an online solutions suite that automates the *** process to ensure efficiency and accuracy.

Offering 2 automatically confirms or adds information to a *** by running the *** through certain programs or commands, called “routines.” Routines can vary in complexity and may be standardized or highly configurable based on customer requests. Customers are not able to remotely access the Offering 2 applications and therefore all configuration is completed by Taxpayer’s technicians in response to specific requests made by the customer. Examples of routines include, but are not limited to, ***.

Once a *** is sent to the Offering 2 queue for validation, Offering 2 automatically applies the different routines. Depending on the customer configurations, a single *** could have over 50 routines. If the *** passes all routines, Offering 2 can ***. However, if the *** fails any one of the routines, Offering 2 automatically sends the *** back to the customer’s “Reject Queue.” The *** must correct the *** and either send the corrected *** back through Offering 2’s *** process or the *** can manually *** themselves.

Offering 2 also automates other manual tasks performed by ***, such as ***. Further, Offering 2 automatically generates customer reports that contain *** information, based on the customer’s requests. Reports can include information such as *** and compliance with *** policies. All of the Offering 2 automated features create efficiencies for ***.

Fees for Offering 2 can be based on a combination of a fixed monthly fee, fees per transaction, and fees for any additional services utilized.

Offering 3 Overview

Offering 3 is an internet-based task management application for ***. Offering 3 automates the management of manual tasks, tracks *** productivity, and identifies process error trends. For instance, Offering 3 allocates *** processing tasks to individual *** based on ***’s availability and skill sets. Offering 3 also tracks the task completion time and provides reports segmented by task category and individual ***. Offering 3 can be remotely accessed by the customer to configure automated tasks. In addition to automating tasks, Offering 3 allows *** to create their own tasks, such as telephone calls, e-mails, and special projects.

Fees for Offering 3 may be based on a flat rate as well as usage fees, depending on the customer.

Offering 4 Overview

Offering 4 is an internet-based application that allows users to access on-demand dashboards to consolidate and simplify *** data from back-office systems. Offering 4 customers remotely access the application to make use of the application's online data management tools and generate reports. Based on the customer's specifications, Offering 4 generates reports that allow *** to identify savings in addition to solving other *** data management challenges. For example, Offering 4's data management and credit card data management applications allow *** to consolidate data from their own back-office systems, credit card providers, vendors ***, and other sources. Further, Offering 4 also provides *** management tools as well as currency converter tool.

Fees for Offering 4 include one-time fees (implementation fees and proprietary back-office interface design fees) as well as transactional fees based on usage.

DISCUSSION & LEGAL ANALYSIS:

Whether the sale of computer software is subject to transaction privilege tax is dependent upon the nature of the software. First it must be determined whether the software constitutes pre written software ("canned software") or custom software.

The sale of canned software is a sale of tangible personal property subject to tax under the retail classification. Canned 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 originally been designed for one specific customer but which becomes available for sale to others. The creation of a generally marketable software program, which will be used by no one particular customer, is not a service.

A.R.S. § 42-5071 Personal property rental classification, imposes the transaction privilege tax on persons engaged in the business of renting or leasing tangible personal property for a consideration. The tax base for this classification is the gross proceeds of sales or gross income derived from the business. All leases of tangible personal property in Arizona are subject to tax under this classification unless specifically deducted or excluded by statute.

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

The provision of a canned computer program, whether or not characterized as a license agreement, is a taxable retail sale. Leases or rentals of canned computer software are taxable under the personal property rental classification.

When canned software is installed, modifications may be made such as supplying requisite parameters and data for the program to perform on certain hardware. The modification of canned computer software at installation does not transform the canned software into custom software. Canned software includes software that may have originally been designed for one specific customer but becomes available for sale or lease to others. Sales of canned software are considered sales of tangible personal property. Although the sale of the canned software is taxable, the charges for installation are exempt from tax provided the charges for the service are separately stated on the invoice and in the books and records.

In contrast to canned computer software, custom software is software designed exclusively to the specifications of one customer's unique application. The service in this case is the dominant element and involves assessing needs, preparing specifications and developing and writing a program for a specific customer. The sale of such software is the sale of a professional service and not subject to tax.

Whether Taxpayer's gross income derived from its monthly, annual, or flat fees is taxable for TPT purposes is dependent on whether those fees are primarily derived from the rental of tangible personal property.

Consistent with the broad definition of tangible personal property as provided in A.R.S. § 42-5001(17),[1] 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.[2] The Arizona Supreme Court's decision in *State v. Jones*[3] addressed the scope of the taxation of tangible personal property. There, it held

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[1] *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."*

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

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.

Significantly, in applying the broad definition of tangible personal property, numerous courts have concluded that software is tangible personal property and subject to tax.[4] In *Wal–Mart Stores, Inc. v. City of Mobile*,[5] the court held software was tangible personal property noting :[6]

> 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. Thus, software is generally accepted to be tangible personal property, and in this case, the software offered by Taxpayer is tangible personal property for TPT purposes.

A.R.S. § 42-5071 imposes 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 tax base for this 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.” A.A.C.R15-5-1502(D) specifically provides that:

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[4] 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”).

[5] 696 So.2d 290 (Ala.1996)

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

> 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*,[7] 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.[8]

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.[9]

The pivotal question, then, is whether Taxpayer's customers gain sufficient control and use of its software to constitute the rental of tangible personal property. 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 the software is not definitive. The *Peck* Court noted:

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

> 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.[10]

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. In addition, 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. Thus, the manipulation required for specific software is likely consistent with the way it is typically.

As to Offering 1, Taxpayer's customers have the right to redistribute, sublicense, rebrand, and resell Offering 1. Customers configure Offering 1 with various rules and policies. At each level, the customer is able to customize what it needs based on its level of sophistication by manipulating the software. As to Offering 2, Taxpayer configures the applications in response to requests. Its customers are able to craft the configurations to suit their needs. This Offering is then charged at a monthly fee. As to Offering 3 and 4, the customer configures automated tasks. It is clear that the use made of the software by the customers amounts to manipulation of the said software. Therefore, Taxpayer's customers manipulate its software so that they have possession and control to constitute a rental within the meaning of the personal property rental classification.

For remote access software arrangements like the one offered by Taxpayer, the server location where the software and files are "physically" stored makes no difference for Arizona TPT purposes. It is the location where a user uses the software that is essential. As such, Taxpayer's gross receipts derived from the rental of tangible personal property in the form of software are taxable when received from Arizona customers. The flat monthly

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

fees charged are also taxable for TPT purposes since those designers are also making use of the software.[11]

The tax base for the personal property rental classification is the gross proceeds of sales or gross income derived from the business and includes all fees and charges associated with the rental of tangible personal property and is not limited to only those fees or charges identified as "rent." A.A.C. R15-5-1502(D) specifically indicates that other fees are included as part of the personal property rental tax base even if such fees are separately stated. Thus, in addition to fees collected under Offerings 1, 2, 3 and 4, the following fees[12] collected by Company are also included in its tax base under the personal property rental classification:

- Transaction Fees under Offering 1
- Implementation Fees under Offering 1
- Marketing Fee under Offering 1
- Distributor Fee under Offering 1
- Transaction Fees under Offering 2
- Access Fee under Offering 3
- Implementation Fees under Offering 4
- Historical Data Transaction Load Fee under Offering 4
- Proprietary Interface Design Fee under Offering 4
- Consulting Services Fees under Offering 4
- Consulting Fees under Offering 4

A.R.S. § 42-5040 provides for the sourcing of transactions involving leases of tangible personal property.

> C. The gross receipts from leasing or renting tangible personal property shall be sourced as follows:
> 1. To the lessor's business location if the lessor has a business location in this state.
> 2. To the lessee's address if the lessor does not have a business location in this state. The gross receipts are taxable when the property is shipped, delivered or otherwise brought into this state for use in this state.

[11] The Department does not make a determination regarding the taxability of the professional designers' business activities for TPT purposes.
[12] The Department does not make a determination whether these fees are derived from a separate line of business because *** considers them inconsequential and incidental to its core business.

D. For the purposes of this section:
1. "Lessee's address" means the residential address of an individual lessee and the primary business address of any other lessee.
2. "Lessor's business location" means the business address that appears on the lessor's transaction privilege tax license.

A.A.C. R15-5-1503 *Sourcing of Leased Tangible Personal Property,* addresses sourcing the tax on tangible personal property leased in Arizona.

A. In this Section:
   1."Business location" means the business address that appears on a lessor's privilege license, but if the lessor does not have a business address in Arizona, business location means the lessee's residential or primary business street address.
   2."Source" means to determine the location of leasing or renting activity for tax purposes.
B. The personal property rental classification applies to a person who is engaging or continuing in the business of leasing or renting tangible personal property in Arizona for a consideration. Gross receipts from leasing or renting tangible personal property in Arizona are taxable under this classification.
C. The Department shall source gross receipts from leasing or renting tangible personal property to the business location. Thus, gross receipts of a lessor without a business address in Arizona, derived from leasing or renting tangible personal property, are sourced to the lessee's residential or primary business street address and are taxable when the property is shipped, delivered, or otherwise brought into the state for use in Arizona.
D. 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.
E. Gross receipts from leasing or renting tangible personal property are not taxable if the property is removed from the state and used exclusively outside of the state. Intermittent use of tangible personal property outside of the state does not constitute removal of the property from the state for use exclusively outside of the state, and therefore does not change the business location of the property or liability for the tax. For example, use of a business's leased tangible personal property by its employees at different locations on business trips and service calls does not change liability for the tax.

F. The burden of proof for establishing the applicability of subsection (D) or (E) is on the lessor.
G. For leasing or renting activity related to a motor vehicle, the Department shall examine whether the motor vehicle is licensed, registered, or primarily used in Arizona.

Pursuant to A.R.S. § 42-5040 and as further clarified in A.A.C. R15-5-1503, gross receipts derived from the business of leasing or renting tangible personal property in Arizona for a consideration is sourced to the "business location." Both statute and administrative rule define "business location" as "the business address that appears on a lessor's privilege license, but if the lessor does not have a business address in Arizona, business location means the lessee's residential or primary business street address."

This response is a taxpayer information ruling (TIR) and the determination herein is based solely on the facts provided in your request dated September 17, 2015. 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.