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Governor

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Director

PRIVATE TAXPAYER RULING LR20-001

January 21, 2020

Thank you for your letter dated September 13, 2018, requesting a private taxpayer ruling on behalf of your client, *** ("Taxpayer"). Specifically, you ask whether Taxpayer's gross income from its business is subject to Arizona transaction privilege tax ("TPT").[1] 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:

Does Taxpayer's utilization of a temporary, nontransferable software license to provide its clients with the ability to access and view Taxpayer-created reports constitute a taxable sale, lease, or rental of the software for purposes of Arizona TPT?

RULING:

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

Taxpayer's utilization of a temporary, non-transferable software license to provide its clients with the ability to access and view reports created by Taxpayer is neither a retail sale nor a taxable lease or rental of prewritten software. Taxpayer is not leasing or renting such software to its clients: the clients lack the requisite level of control, and it is Taxpayer, not Taxpayer's clients, that uses the software to provide the Taxpayer's reports to its clients.[2]

Instead, Taxpayer's receipts are derived from designing surveys, gathering information, analyzing information, and providing results, insights, and solutions obtained from data analysis, which constitute nontaxable service activities. The temporary, non-transferable license that Taxpayer provided to clients to view survey results is an inconsequential element of the nontaxable services provided by Taxpayer.

SUMMARY OF FACTS:

[1] Except as otherwise required by the context, in this ruling, "TPT" or "Arizona TPT" refer collectively to privilege taxes levied by the state and any associated county and municipal privilege taxes.
[2] *See State Tax Commission v. Peck*, 106 Ariz. 394, 476 P.2d 849 (1970) (en banc).

The following is a summary of the relevant facts based on your letter dated September 13, 2018 and subsequent correspondence with the Department dated October 31, 2018:

Taxpayer is a company that provides business services to clients. Taxpayer primarily focuses on structuring a client's business through developing surveys, gathering information, analyzing that information, and providing insight and solutions derived from such business analysis. Specifically, Taxpayer's business services target three major areas:

1) The client's customers and their experiences with the client,
2) The client's employees and their level of engagement with the client, and
3) Enhancement of the client's brand and perceptions of that brand.

Each client engagement requires Taxpayer to provide insight into the client's business, collect survey data, manipulate that data, and ultimately deliver the results of such work to the client. Taxpayer develops the surveys in coordination with the client. The surveys can include e-mail surveys, online surveys, mobile device surveys, and surveys conducted over social medial channels. After Taxpayer develops the survey methods, Taxpayer conducts the survey to gather information from the specific populations requested by its customer.

After it receives survey data, Taxpayer inputs the data into a software program called ***. Taxpayer provides the client with a temporary, non-transferable license to access *** to view the reports that contain the survey results and other data received. *** is web-based and is not downloaded by the client. The amount of information provided on *** is customized for each client and the variety of dashboards that are offered on *** allows clients to view survey data in the format that best fits their needs. *** has "cards" that are configurable to generate reports that the client wants.

The software is a tool Taxpayer uses to deliver the results of its services to its client. Taxpayer typically uses *** to provide the reports of the surveys and other information gathered; however, clients can request paper copies of these reports. Taxpayer does not separately charge the client for access to ***. When Taxpayer's relationship with a client terminates, the client will no longer be allowed to access ***.

DISCUSSION & LEGAL ANALYSIS:

Arizona TPT differs from the sales tax imposed by most states. It is a tax on the privilege of conducting business in the State of Arizona. Differing from a true sales tax, TPT is levied on gross proceeds of sales or gross income derived by the business owner, who may legally pass the economic expense of the tax on to the customer. TPT is imposed under sixteen

separate business classifications, including the personal property rental and retail classifications. All receipts subject to state-levied TPT are also subject to county excise taxes.

The imposition of city privilege taxes is separate and distinct from state TPT and county excise taxes. The Model City Tax Code ("MCTC") was created in order to impose and administer city privilege taxes. Similar to Arizona's TPT, city privilege taxes are imposed on the vendor on account of their business activities in the city.[3] All Arizona cities follow the MCTC in their imposition of their privilege tax based upon their local adoption of its ordinances. However, certain options exist, allowing each city to alter or qualify the imposition of its privilege tax.

Digital Products as Tangible Personal Property

A.R.S. § 42-5001(21) defines "tangible personal property" as "personal property that may be seen, weighed, measured, felt or touched or that is in any other manner perceptible to the senses." Consistent with this broad definition, there is longstanding precedent in case law for the scope of tangible personal property to encompass more than simply physical goods, including such subjects as electricity and music played from a jukebox.[4] Significantly, numerous courts have concluded that software is tangible personal property and subject to tax.[5]

In this case, Taxpayer helps structure a client's business by designing surveys, gathering data, analyzing information, and providing results along with insights and solutions obtained from data analysis. Taxpayer uses *** to deliver results to its clients and provides its clients with a *** license to allow them to review the reports Taxpayer created for them. ***, as software, is a digital form of tangible personal property.

As such, the next step is to ascertain whether Taxpayer derives taxable receipts from selling or renting software, or if such receipts are nontaxable because they are derived from an inconsequential transfer of tangible personal property as part of Taxpayer's performance of a nontaxable service activity.

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[3] *See* MCTC § 400(a)(1).
[4] *See State Tax Comm'n v. Marcus J. Lawrence Mem. Hosp*., 495 P.2d 129 (Ariz. 1972) (en banc); *State v. Jones*, 37 P.2d 970 (Ariz. 1943).
[5] *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*, 848 N.E.2d 499 (Ohio 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").

Retail Sales

A.R.S. § 42-5061 imposes TPT under the retail classification. The retail classification is comprised of the business of selling tangible personal property at retail. The tax base for the retail classification is the gross proceeds of sales or gross income derived from the business. All sales of tangible personal property are subject to TPT under the retail classification unless specifically exempted or deductible by statute. The city privilege tax analog to A.R.S. § 42-5061 is found in MCTC § -460.

Leases and Rental of Tangible Personal Property

A.R.S. § 42-5071 imposes TPT 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. Cities and towns tax the rental, leasing, or licensing for use of tangible personal property under MCTC § -450.

Nontaxable Services Occupations and Businesses

A.R.S. § 42-5061(A)(1) exempts "[p]rofessional or personal service occupations or businesses which involve sales or transfers of tangible personal property only as inconsequential elements." MCTC § -460(c)(5) provides a similar exemption for professional service businesses as at the state level, such that services that are exempt for state and county tax purposes would likewise be exempt for city privilege tax purposes.

The Department discusses the nature of professional and personal service occupations and businesses in Arizona Transaction Privilege Tax Ruling TPR 90-2 (Aug. 1, 1990). Professional and personal service occupations are those where the professional is able to engage in the occupation by virtue of a state sanctioned or state issued license to engage in that occupation (*e.g.*, lawyers, doctors, cosmeticians, barbers). A service business is one whose dominant purpose is to provide a service rather than to fabricate and sell the goods fabricated. [6] Examples of service businesses include vehicle maintenance garages, pest control, lawn maintenance and other like services.

[6] Additionally, Arizona case law provides that under the dominant purpose test, "if the dominant purpose of the transaction is a service, then the transaction is not taxable." *See generally Qwest Dex, Inc. v. Arizona Department of Revenue*, 109 P.3d 121,123 (Ariz. Ct. App. 2005).

The A.R.S. § 42-5061(A)(1) exemption generally covers those inconsequential sales or transfers of tangible personal property used by an occupation or business in the actual operation thereof or to facilitate the service provided (*e.g.*, shampoo used by a hair stylist to wash a customer's hair). In *Val-Pak East Valley, Inc. v. Arizona Dept. of Revenue,*[7] the court examined whether the purchase of printed mail advertising coupons was the sale of tangible personal property as opposed to a service for Arizona TPT purposes. The court held that the direct mail was a service because, while the flier would be considered tangible personal property, the person requesting the design of the advertising flier was not paying for the paper, but was paying for the design services. Thus, the transfer of the paper was an inconsequential element of the service provided.

Because the transactions at issue in this ruling involve transfers of a digital form of tangible personal property (*i.e.*, the *** software application), it is necessary to determine whether such transfers constitute: (1) retail sales; (2) leases or rentals; or (3) inconsequential transfers of tangible personal property in the performance of a nontaxable service activity. When a taxpayer grants its clients the right to software for a perpetual duration (*i.e.*, in a sale), it is appropriately taxable under the retail classification. If, on the other hand, a taxpayer grants its clients the right to use software for a fixed period of time at a fixed amount, it is appropriately taxable under the personal property rental classification.

The clients' right to use *** to access data ceases when the contractual relationship with Taxpayer ends. Because clients do not have a right to software for a perpetual or indefinite duration, the analysis turns to whether Taxpayer is renting the *** software, or merely providing the software as an inconsequential element of performing a nontaxable service.

Determining Whether a Taxable Software Rental Exists

Several Arizona cases further illustrate the difference between a lease or rental that is taxable under the personal property rental classification versus the provision of one or more nontaxable services.

In *State Tax Commission v. Peck*, the Arizona Supreme Court held that TPT applied to the receipts from coin-operated laundromats and automated car washes.[8] The court held that when customers deposited money into the machines, they were renting them because they obtained *exclusive use and control* over them for a set period of time.[9] The fact that the business owners provided the premises and utilities needed for their operation did not

[7] 229 Ariz. 164 (App. 2012).
[8] 106 Ariz. 394, 394 (1970) (en banc).
[9] *Id.* at 396.

diminish the requisite control or possession over the equipment.[10] Moreover, the businesses did not provide the level of "personal services" needed to render the activities exempt services under A.R.S. § 42-5061(A)(1) rather than taxable leases or rentals.[11]

In *City of Phoenix v. Bentley-Dille Gradall Rentals, Inc.*, the Arizona Court of Appeals held that a business that provided construction equipment with operators was engaged in contracting rather than renting tangible personal property.[12] Because the business's employees had physical control of its equipment at all times at customers' job sites, and the business determined the equipment to be provided and was liable for work performed by its operators, no possession or control was relinquished to the business's customers so as to constitute rental activity.[13]

The Court of Appeals next held in *Energy Squared, Inc. v. Arizona Department of Revenue* that a tanning salon was engaged in the provision of exempt personal services, not the rental of tangible personal property.[14] The court rejected the Department's assertion that the salon's receipts were derived from renting tanning beds and booths for a set period of time, noting that:

1. It was unclear whether the Legislature intended for the salon's activities to fall within the scope of the personal property rental tax classification, and thus the ambiguity had to be resolved in the taxpayer's favor;
2. Customers lacked exclusive control over running the tanning beds and booths, because salon employees had control over access to the equipment, duration of use, and appropriateness of use; and
3. Salon employees provided a true "service" component to customers by providing advice and decisions made in the course of the customers' tanning process.[15]

Because of the degree of control reserved by the tanning business as compared to the control ceded to patrons, combined with the level of service the business provided to the customers, the salon constituted a nontaxable service business.[16]

Finally, in *Jones Outdoor Advertising, Inc. v. Arizona Department of Revenue*, the Court of Appeals held that a billboard advertising business was not engaged in renting tangible

[10] *Id.*
[11] *Id.*
[12] 136 Ariz. 289, 290 (App. 1983).
[13] *Id.* at 291-92.
[14] 203 Ariz. 507, 511 (App. 2002).
[15] *Id.* at 510-11.
[16] *Id.* at 511.

personal property, but rather, was exempt as a nontaxable advertising service.[17] Although it acknowledged that billboards constituted tangible personal property, the court observed that the business's clients lacked sufficient control over the billboards during the contract term.[18] The billboard company retained ownership of the billboards and printed vinyl coverings, had sole control over access to the billboards, and even had the right to "relocate and assign the advertisement to another billboard location."[19] The billboard company's customers merely paid for the right to display their messages on the billboards, which resembled consideration paid for advertising—an activity that the Legislature explicitly repealed the state-level tax for from and after 1986.[20]

From the above cases, the critical question is whether Taxpayer's clients obtain a level of control and use of the *** software sufficient to constitute the rental of tangible personal property. Taxpayer's characterization of the agreement under which Taxpayer's clients were able to use or access the *** software as a "license" does not conclusively determine whether requisite control or use exists. Additionally, as may be gleaned from *Peck*, sufficient use or possession for purposes of a taxable lease or rental does not require physical removal of the tangible personal property at issue by a customer: use on the tangible personal property in place is enough.[21]

Taxpayer's facts state that clients access *** software for purposes of viewing the compiled survey data and reports, depending on the modules chosen. Thus, the question is whether such access is sufficient to deem clients to have the requisite control and use of the software found in a rental of tangible personal property.

Based on the facts presented, Taxpayer uses *** software to deliver the results of its data collection and analysis activities to its clients. Taxpayer accomplishes this by itself using the software to customize the reports to each client's needs: in this sense, Taxpayer uses the software to dictate the data that the client subsequently accesses the software to view. The client then chooses to receive the reports through *** or paper copies.

It is clear that Taxpayer is retains primary use and control of the *** software throughout the entire process, from the time that Taxpayer inputs data into the software to when Taxpayer terminates a client's access to view reports on *** when its contract with the client ends. Manipulation of the software and controls set through *** to customize reports for clients are performed by Taxpayer, not clients. The level of nontaxable service activities performed by

[17] 238 Ariz. 1, 4 (App. 2015).
[18] *Id.* at 3.
[19] *Id.*
[20] *Id.* at 4.
[21] 106 Ariz. at 396.

Taxpayer in survey design, implementation, and analysis are high relative to the limited access to view reports provided to clients—in fact, the fees Taxpayer charges are based on these service activities rather than software usage.

For these reasons, the Department rules that Taxpayer is not engaged in the business of renting or licensing the *** software to clients.

Transfer of Software as an Inconsequential Element of Nontaxable Service Activities

Based on the information received, the Department rules that Taxpayer's business activities constitute nontaxable service activities under A.R.S. § 42-5061(A)(1) and is not taxable for Arizona TPT purposes. The dominant purpose of the transaction is to provide clients with business solutions services through designing surveys, gathering information, analyzing information and providing the survey results along with insights and solutions. As noted above, fees are based on Taxpayer's performance of these activities: clients are not paying for the temporary non-transferable *** license to view survey results, but are paying for the business services Taxpayer is providing. The *** license provided to clients to access and view survey results is considered an inconsequential element of the services provided by Taxpayer.

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. 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.