STATE OF ARIZONA
Department of Revenue

March 23, 2020

Douglas A. Ducey
Governor

Carlton Woodruff
Director

Thank you for your letter requesting a private taxpayer ruling (PTR) on behalf of your client ******* (Taxpayer). Specifically, you requested a ruling regarding the applicability of Arizona use tax to Taxpayer's products and supplies stored and tested in warehouses prior to being shipped outside the state. Pursuant to Arizona Revised Statutes (A.R.S.) § 42-2101, the Arizona Department of Revenue (department) may issue private taxpayer rulings to taxpayers and potential taxpayers on request.

ISSUE:

Whether the Taxpayer is subject to the Arizona use tax on the cost of products and supplies stored and tested in its Arizona warehouse prior to being shipped outside the state.

RULING:

The department rules that the Taxpayer is not liable for Arizona use tax for tangible personal property brought into Arizona for storage if the tangible personal property:

- is purchased for bona fide use or consumption outside of Arizona,
- is not used in conducting a business in Arizona,
- is located in Arizona temporarily, with the storage time not to exceed thirty (30) days,
- is prepared for actual use by Taxpayer outside the state, and,
- is, in fact, first used by the Taxpayer outside the State.

Generally, tangible personal property brought into Arizona and stored for ninety (90) days or more or subsequently used in the business in Arizona would be subject to Arizona use tax.

To substantiate first actual use outside Arizona, Taxpayer must have documentation to evidence where use tax was paid when either (a) the property was temporarily stored and prepared for use in Arizona but actually used in another state or (b) the property was temporarily stored and prepared in another state but actually used in Arizona. This applies to all assets appearing on Taxpayer's Arizona books and accounts whether temporarily here or otherwise. To the extent that it may assist the Taxpayer in calculating its use tax liability, Taxpayer may, under A.R.S. § 42-5168, request that the department issue a letter of authorization to use a percentage based reporting method.

FACTS ASSERTED BY TAXPAYER:

The following is a summary of facts provided by Taxpayer in its ruling request dated February 28, 2019 and, subsequently, its letters dated May 16, 2019 and January 15, 2020:

The Taxpayer is a financial services company with locations nationwide, including locations in Arizona. It employs about ******* people, and makes available computer equipment to its employees for use in conducting Taxpayer's business. Employee computer equipment is usually replaced 42 months after it is put into service. The Taxpayer has three warehouses used to store, and later supply, its locations both inside and outside Arizona with new computer equipment, as needed. One of those warehouses is located in Phoenix, Arizona.

Equipment, including computer hardware, computer software and other equipment, is purchased from large, national retailers and shipped directly to warehouses located around the country, including Arizona. The equipment is not put into service until it is shipped from the warehouse to its intended service location and used by Taxpayer's employees. The equipment is expected to remain permanently at its intended service location. Most permanent intended service locations are outside Arizona.

Equipment received at the Arizona warehouse undergoes acceptance testing and bundling with other tangible personal property before shipment to its intended service location. This involves the following steps:

- Volume shipments are received and separated into individual units.
- The Taxpayer's staff installs software.
- The Taxpayer's staff performs function testing to determine if each piece of equipment is acceptable or defective.
    - Function tests include checking to ensure that the system
        - powers on;
        - certain canned software is installed and running; and
        - power down.
- Products that fail any of the above steps are returned to the manufacturer.
- Products that pass function testing are re-boxed and placed in storage until shipped to the intended service location.
    - This usually takes three to four weeks.
    - Software installed during function testing remains on the system of the computer.

It is important to note that the canned software installed on the new equipment is subscription based. As such, the software is likely subject to TPT under the personal property rental classification. Taxpayer has confirmed that this is the case and that the lessor of the software is charging Taxpayer

TPT on the rental. As such, the taxability of the canned software loaded on the computers is not addressed in this ruling.

All purchased equipment is intended to be used by the Taxpayer's employees performing their usual job functions. This cannot occur until the equipment is shipped from the Arizona warehouse to a company work location. Equipment that has remaining useful life, but is no longer needed at the work location, is sometimes returned to the Arizona warehouse after being used outside of Arizona. This typically occurs when an employee leaves the Taxpayer's employ. Equipment returned to the Arizona warehouse is checked for functionality before being stored in the warehouse.[1]

Taxpayer cites to A.R.S. § 42-5151(20) definition of "storage" for use tax purposes to support its position that Taxpayer is not subject to Arizona use tax on the cost of property temporarily stored in Arizona and subsequently used solely outside the state. Taxpayer also cites to *Salt River Project Agricultural Improvement and Power District v. City of Tempe*, 708 P.2d 1335 (Ariz. App. 1985) for the conclusion that products stored in one jurisdiction that are ultimately used in another jurisdiction are not deemed "used" in the former jurisdiction for purposes of use tax as such temporary storage falls outside the scope of storage activity, based on the definition of "storage" in Tempe's municipal tax code that was nearly identical to the state's. The appellate court held that the City of Tempe could not impose a use tax on the storage of property in Tempe where the property was used outside the city limits.

DISCUSSION & LEGAL ANALYSIS:

A.R.S. § 42-5155(A) imposes Arizona use tax on "the storage, use or consumption in this state of tangible personal property purchased from a retailer or utility business, as a percentage of the sales price." A.R.S. § 42-5155(F) further provides that use tax liability falls upon the person who stores, uses, or consumes tangible personal property in Arizona, and that the liability is not extinguished until the tax has been paid.

"Storage" is defined as "keeping or retaining tangible personal property purchased from a retailer for any purpose *except* sale in the regular course of business or *subsequent use solely outside this state*." A.R.S. § 42-5151(20) (emphasis added). A.A.C. R15-5-2304(B) explains that tangible personal property brought into Arizona is presumed to be subject to use tax, and that the burden of proof that the purchase is not subject to use tax falls upon the purchaser. A.A.C. R15-5-2304(A) explains that property purchased out-of-state and brought into Arizona is subject to use tax unless the property is not used in the conduct of business in Arizona and the property was purchased for *bona fide* use or consumption is outside of Arizona. The phrase "bona fide" is not defined in the statute.

[1] Taxpayer should have the proper documentation to verify taxes were paid on equipment returned to the warehouse after use.

It is a legal term of art which means "good faith." *Baseline Liquors v. Circle K Corp.*, 630 P.2d 38, 43 (Ariz. App. 1981) (the term "bona fide" has a well settled meaning in law as "made in good faith without fraud or deceit …sincere … genuine") Black's Law Dictionary defines bona fide as "[i]n or with good faith; honestly, openly, and sincerely; without deceit or fraud…"[2]

A.R.S. § 42-5151 defines "use or consumption" as the exercise of any right or power over tangible personal property incidental to owning the property except holding for sale or selling the property in the regular course of business.

The imposition of city privilege taxes is separate and distinct from the state's TPT and accompanying county excise taxes. As with the state's TPT, city privilege taxes are imposed on the vendor for the privilege of engaging in business in the city. 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 "upon persons on account of their business activities." See MCTC § -400(a)(1). All Arizona cities follow the MCTC in the imposition of their privilege tax based upon their local ordinances. However, certain options exist, allowing each city to alter or qualify the imposition of its privilege tax.[3] The City of Phoenix imposes a use tax for the use or storage within the city as described in the Phoenix City Code §14-610. The Phoenix City Code § 14-660(a) allows for a use tax exemption on the storage or use in a city of tangible personal property brought into the city by an individual who was <u>not</u> a resident of the city at the time the property was acquired for his own use, if the first actual use of such property was outside the city, unless such property is used in conducting a business in this city.

(1) Whether the computer equipment and other property is stored in Arizona triggering application of use tax:

Although property may be stored in Arizona, a temporary storage does not necessarily trigger application of the use tax if the property is intended to be used in another jurisdiction. *See Salt River Project Agr. Imp. & Power Dist. v. City of Tempe*, 708 P.2d 1335, 1337. The department agrees with Taxpayer's analysis, and rules that the equipment and other property temporarily stored in Arizona but which is subsequently used outside Arizona is not subject to use tax since it does not meet the statutory definition of storage.

(2) Whether the computer equipment and other property is used in Arizona, triggering application of use tax

[2] Black's Law Dictionary 10th Edition (2014).
[3] The MCTC can be found online at https://modelcitytaxcode.az.gov.

Arizona courts have not directly addressed the issue of first use, actual use or bona fide use concerning computers. Some guidance is available in *PCS, Inc. v Arizona Department of Revenue,* 925 P.2d 680 (Ariz. App. 1995), wherein the appellate court had to decide what would be considered "usage" within the meaning of use tax and when a mere preparation for intended use constitutes "the actual use." In that case, the company (PCS) processed and distributed plastic identification cards to third parties. Once the cards were no longer required, they were cancelled electronically.[4] The court concluded that PCS was not merely preparing the tangible personal property for their subsequent use but was using them for *the only purpose which it would ever employ them* (emphasis added).[5] "Specifically by encoding and stamping black cards, *PCS* was not merely preparing to use them, it was using them for the only purpose for which it, as opposed to its clients and their beneficiaries, would ever employ them."[6] PCS's business was to prepare the cards for use.[7] Once PCS processed and distributed the cards, the company would not have any more dealings with the cards.[8] Thus, the actual use was therefore the preparation of the cards.

Dahlberg Hearing Systems, Inc. v. Commissioner of Revenue, 546 N.W.2d 739 (Minn. 1996), a case with similar facts to those under consideration, may also be consulted even though it is not controlling in Arizona. In that case, the company loaded the computer with software and tested the equipment then shipped the computer equipment out-of-state. Specifically, computer equipment arrived at the facility, personnel unpacked the computer equipment and copied software into each computer's hard drive.[9] Dahlberg would connect the computer, printer and modem with cables.[10] Once tested, the equipment was disconnected and re-boxed and sent out of the state.[11] Once at the final destination, the equipment was installed and used.[12] That court concluded that the company was merely preparing the computer for use and the computer's intended use did not take place until it was in another state and used for its purpose by their franchise.[13]

Whether couched in language "subsequent use solely outside the state" or "first use outside the state" the question really is where actual use occurs and which jurisdiction Taxpayer must pay the use tax. Here, Taxpayer indicates that, upon acquiring computers, software and other equipment, these products are bundled (software is installed and tested for functionality), and later pre-packaged and stored to be shipped to others outside the state. The equipment is stored for no longer than 3-4 weeks (30 days) before being shipped. It appears that while the computers are being

[4] *Id*. at 681
[5] *Id.*
[6] *Id.* at 683.
[7] *Id.* at 681.
[8] *Id.*
[9] *Id*. at 741.
[10] *Id*.
[11] *Id*.
[12] *Id.*
[13] *Id.*

prepared for their intended use in Arizona, their actual use occurs outside of Arizona. Imaging computers to add software and testing their functionality is not the actual use. The actual use of the computers occurs when it is shipped outside of Arizona to the employee who uses it for their job function.

This case can be distinguished from the *PCS* case where the only use was preparatory use. As the court in *PCS* noted:

> What distinguishes . . . similar decisions on which PCS relies is that in each of them only a single entity—the taxpayer—engaged in the activities constituting "preparation for use" and "use." The only question in each case concerned which of the two jurisdictions was the one where the "use" had occurred. In contrast, PCS's use of the blank plastic cards occurred in Arizona, and only persons and entities other than PCS made any further use of the items. By encoding and stamping the blank cards, PCS was not merely preparing to use them, it was using them for the only purpose for which it, as opposed to its clients and their beneficiaries, would ever employ them.[14]

As part of establishing that Taxpayer actually uses the equipment under question outside of Arizona, Taxpayer must be able to document that use tax was paid on equipment under question outside of Arizona. To substantiate first actual use outside Arizona, Taxpayer must have documentation to evidence where use tax was paid when property is temporarily stored and prepared for use in Arizona and is actually used in another state and where property temporarily stored and prepared in another state is actually used in Arizona. This applies to all Arizona assets appearing on Taxpayer's Arizona books and accounts whether temporarily or otherwise. Property remaining in Arizona for 90 days or more is presumptively subject to the use tax.

If Taxpayer stores computers in another state and ships them to business locations in Arizona for use by employees in Arizona, Taxpayer would be responsible for remitting use tax in Arizona.

Documentation

Although there is no statute or administrative rule that explicitly governs the documentation requirements for establishing subsequent or bona fide use outside the state, guidance may be similar to those found in an exempt retail sale of tangible personal property made in interstate or foreign commerce under the A.R.S. § 42-5061 the retail classification for TPT purposes.[15] A.A.C. R15-5-

[14] PCS, 925 P.2d 680, 683

[15] To satisfy this retail exemption, A.A.C. R15-5-170(A) explains that a retail business needs to demonstrate that the order was received from a location outside of Arizona and that it subsequently ships or delivers the tangible personal property to a location outside of Arizona for use outside of Arizona.

170(C) provides guidelines for substantiation purposes and can be a good reference guide, but the list is not exhaustive. [16]

Additionally, A.R.S. § 42-5168, provides a means for the department to authorize certain taxpayers to use a percentage based reporting method for use tax. The method provides a more flexible means for taxpayers and the department to arrive at standards that taxpayers can use to calculate their use tax liabilities, by taking into consideration such factors as dollar amount, the type of tangible personal property at issue, the purposes for which the property are used, and "other standards that are appropriate to the taxpayer's operations." *See* A.R.S. § 42-5168(B).

Taxpayer must separately account for the portion of products or supplies that is stored for use within Arizona – and, thus, subject to Arizona use tax – and the portion that is to be subsequently used solely outside of Arizona. By the same token, property purchased and stored in another jurisdiction and then brought to Arizona for use taxable for Arizona use tax purposes and must similarly be accounted for. Taxpayer must be able to demonstrate exactly where TPT or use tax was paid on all its fixed assets.

Conclusion

Based on the above analysis, the department rules that the Taxpayer is not liable for Arizona use tax on tangible personal property if it is purchased from outside the state and temporarily stored for one month or less in Arizona where it undergoes preparation for use before being shipped or delivered outside the state for its ultimate use by Taxpayer outside the state. In such cases, the use taxes are paid in the jurisdiction in which the equipment is used. However, property that remains in Arizona for more than three months is presumed taxable unless shown otherwise. A.A.C. R15-5-2304(A)(2). Likewise any property shipped to and tested in another state and then brought into Arizona for use here would be subject to Arizona's use tax. Finally, if the circumstances were such that preparatory use was its only use of the property, then such preparatory used would be deemed as actual use following the *PCS* case.

The Taxpayer has the burden to prove that the property was not used in conducting a business in Arizona and the property was purchased for a bona fide use for outside of Arizona. Taxpayer must have documents to substantiate the claim and can look to A.A.C. R 15-5-170(C)(2) for guidance. To the extent that it may assist the Taxpayer in calculating its use tax liability, it may, under A.R.S. § 42-5168, request that the department issue it a letter of authorization to use a percentage based reporting method.

[16] The list provided includes bill of lading, parcel post receipt, export declaration, receipt from a licensed broker; or proof of export or import signed by a customs officer.

This private taxpayer ruling does not extend beyond the facts presented in your correspondence of February 28, 2019.

This response is a private taxpayer ruling and the determinations herein are based solely on the facts provided in your request. 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.