DECISION OF MUNICIPAL TAX HEARING OFFICER

Decision Date: May 26, 2010
Decision: MTHO # 497
Taxpayer:
Tax Collector: City of Phoenix
Hearing Date: April 23, 2010

DISCUSSION

Introduction

On March 13, 2009, a letter of protest was filed by ***Taxpayer*** of a tax assessment made by the City of Phoenix ("City"). A hearing was commenced before the Municipal Tax Hearing Officer ("Hearing Officer") on April 23, 2010. Appearing for the City were the ***Assistant City Attorney***, and the ***Senior Tax Auditor***. Appearing for Taxpayer were the ***Senior Manager*** of Deloitte Tax LLP, ***another representative*** of Deloitte Tax LLP, and the ***Tax Director*** for Taxpayer. At the conclusion of the April 23, 2010 hearing, the record was closed. On April 28, 2010, the Hearing Officer indicated a written decision would be issued on or before June 14, 2010.

DECISION

On January 27, 2009, the City issued an audit assessment of Taxpayer. The assessment was for the period of May 2000 through April 2008. The assessment was for additional taxes in the amount of $209,651.60, and interest up through December 2008 in the amount of $70,213.65. Taxpayer is in the business of selling software designed to help purchasers with their information, performance management and reporting needs. The City began contacting Taxpayer in September 2006 by telephone. Taxpayer repeatedly informed the City that the City did not have nexus. The City issued an estimated assessment after Taxpayer stopped responding to the City's telephone calls. The City made the assessment using information from two Arizona Department of Revenue ("DOR") audits of Taxpayer for the periods of May 2000 through September 2004 and October 2004 through April 2006 and invoice information obtained during the audit of a taxpayer doing business with Taxpayer. The City assessed Taxpayer pursuant to City Code Section 14-450 ("Section 450") as licensing for use of tangible personal property. The City noted that City Code Section 14-115 ("Section 115") defines "computer software" which is not "custom computer programming" to be deemed to be tangible personal property. The City indicated that software licensing is a phenomenon of the industry whereby software is licensed rather than sold. The licensor retains ownership

and the licensee is legally prohibited under the license agreement from selling or in any way altering the software. In response to Taxpayer, the City asserted that Section 450 does not have a provision exempting out-of-City sales. While the City had an information brochure that provided all sales of non-custom computer software were sales of tangible personal property, the City argued that was referring to retail sales at stores like Best Buy and not to Taxpayer. According to the City, Best Buy is selling someone else's software while Taxpayer is selling a license for use of Taxpayer's own software.

Taxpayer indicated it did not have a physical presence in the City until December 2007 at which time Taxpayer had an employee working from a home office in the City. Prior to that time, Taxpayer had sales representatives that would come into the City but their stay would be short as they would use a hotel, car, cab, etc. According to the City, the purpose of sales representatives visiting the City, overnight or for short periods is to establish and maintain a market for Taxpayer. The City noted that the location from which the sales person operates is considered the business location of the seller and that jurisdiction has primary claim to tax the transaction. The City opined that Taxpayer did have sufficient nexus within the City pursuant to Arizona Department of Revenue v. Care Computer Systems, Inc., 197 Ariz 414.

Taxpayer is in the business of selling software designed to help purchasers with their information, performance management and reporting needs. Taxpayer's software assists users to access and summarize information into easy-to-use format.

Taxpayer argued that all of its sales to City customers qualify for the out-of-City sale exemption. City Code Section 14-465(b) ("Section 465") defines an out-of-City sale if all the following occur: (1) transference of title and possession occur without the City; and (2) the stock from which such personal property was taken not within the corporate limits of the City; and (3) the order is received at a permanent business location of the seller located outside the City; which location is used for the substantial and regular conduct of such business sales activity. Taxpayer asserted there was no transfer of title or possession within the City. According to Taxpayer, the title transfers to the customer once it leaves the business of its contract manufacturer in California. Taxpayer noted there is no stock maintained within the City. Taxpayer indicated its orders were received and approved from a permanent business location outside the City.

Taxpayer noted that A.R.S. 42-6005(D) ("Section 6005") provides when the State Statues and the Model City Tax Code are the same and where the DOR has issued written guidance, the DOR's interpretation is binding on the cities and towns. In this case, the City relied on the two previous audits of the DOR as the foundation of its assessment. Taxpayer indicated in both audits performed by the DOR, Taxpayer's transactions were treated under the retail classification. Additionally, the DOR has issued rulings which concluded that the licensing of canned software is subject to tax as a sale of tangible personal property at retail unless a specific exemption applies. Taxpayer indicated that in the Decision for MTHO#80, the cities of Glendale, Phoenix, Prescott, and Tempe and the DOR assessed the taxpayer's sales of prewritten software as taxable as a retail sale.
Taxpayer requested all interest to be abated because of erroneous advice or misleading

statements by the City. Taxpayer argued that the City did not follow its own written guidance as well as rulings and guidance from the DOR. Taxpayer also noted that the City initially assessed Taxpayer software sales under the retail classification but subsequently reclassified the sales as a license to use tangible personal property.

While for the majority of the audit period Taxpayer had no property, place of business, or employees in the City, Taxpayer did have sales representatives visiting the City on a regular basis to establish and maintain a market for Taxpayer. We conclude pursuant to Care Computer Systems that there was sufficient nexus with the City to tax transactions by Taxpayer.

After concluding there was sufficient nexus to tax Taxpayer, we must determine whether Taxpayer's transactions should be assessed as retail sales pursuant to Section 460 or as licensing for use pursuant to Section 445. We note that City Code Section 14-100 ("Section 100") defines "licensing for use" to be an agreement which does not qualify as a "sale" or "lease" or "rental agreement". "Sale" is defined as any transfer of title or possession, or both of property for a consideration. "Computer software" is defined in City Code Section 14-115 ("Section 115") to mean any computer program. Custom software which is not "custom computer programming" is deemed to be tangible personal property, regardless of the method by which title, possession, or right to use the software is transferred to the user. Based on the definitions set forth in Sections 100 and 115, Taxpayer's sale of its computer software was a sale of tangible personal property. Section 100 provides it would be a "licensing for use" agreement if there was not a sale, lease, or rental agreement. Since there was a sale, there is no licensing for use agreement. This conclusion is corroborated by the fact the Cities own brochure includes sales of non-custom computer software as sales of tangible personal property. This conclusion is also consistent with the DOR's treatment of Taxpayer. The City attempted to distinguish the sales of other companies' software by a third party retailer such as Best Buy from the sales made by Taxpayer. That distinction is not set forth in the Code. We also note that City Code Section 14-542 ("Section 542") provides that if the City adopts a new interpretation or application of any provision of this Chapter and the change or interpretation or application is not due to a change in the law, the change in interpretation or application applies prospectively only unless it is favorable to taxpayers. We conclude that the City is attempting to change an interpretation or application of a provision in this Chapter and the change is not due to a change in the law. Section 542 makes it clear that any such change can only apply prospectively. Based on all the above, we conclude that Taxpayer's transactions would be taxable pursuant to Section 460.

The next issue is whether or not the sales of software by Taxpayer qualify as exempt out-of-City sales as set forth in Section 465 and Section 100. The requirements for out-of City sales are as follows: 1) Transference of title and possession occur without the City; and 2) The stock from which such personal property was taken was not within the corporate limits of the City; and 3) The order is received at a permanent business location of the seller located outside the City; which location is used for the substantial and regular conduct of such business sales activity. Taxpayer provided invoices which indicated the software was shipped FOB origin. As a result, we conclude the buyer

assumed title and control over the goods the moment the carrier signed the bill of lading. Accordingly, Taxpayer met the first requirement that title and possession occurred outside the City. Taxpayer did not maintain any stock within the City and thus met the second requirement. Lastly, the orders were received at Taxpayer's permanent business location outside the City. As a result, we conclude that Taxpayer's sales were exempt out-of City sales pursuant to Sections 465 and 100. Based on all the above, we conclude Taxpayer's March 13, 2009 protest should be granted.

FINDINGS OF FACT

1. On March 13, 2009, Taxpayer filed a protest of a tax assessment made by the City.

2. On January 27, 2009, the City issued an audit assessment of Taxpayer.

3. The assessment was for the period of May 2000 through April 2008.

4. The assessment was for additional taxes in the amount of $209,651.60, and interest up through December 2008 in the amount of $70,213.65.

5. Taxpayer is in the business of selling software designed to help purchasers with their information, performance management and reporting needs.

6. The City began contacting Taxpayer in September 2006.

7. Taxpayer repeatedly informed the City that the City did not have nexus

8. The City issued an estimated assessment after Taxpayer stopped responding to the City's telephone calls.

9. The City made the assessment using information obtained from two DOR audits of Taxpayer for the periods of May 2000 through September 2004 and October 2004 through April 2006 and invoice information obtained during the audit of a taxpayer doing business with Taxpayer.

10. During the audit period, Taxpayer had sales representatives that would come into the City but their stay would be short as they would use a hotel, car, cab, etc.

11. Commencing in December 2007, Taxpayer had an employee working from a home office in the City.

12. During the audit period, Taxpayer did not maintain any stock in the City.

13. During the audit period, the City had published an informational brochure for taxpayers which indicated sales of non-custom computer software were sales of tangible personal property.

14. The informational brochure did not distinguish sales of other companies' software by a third party retailer from the sales made directly by a software company to its customers.

15. The DOR treated Taxpayer's transactions as sales of tangible personal property.

16. During the audit period, Taxpayer shipped the software to customers FOB origin.

17. During the audit period, Taxpayer received and processed orders at its out-of-State business location.

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CONCLUSIONS OF LAW

1. Pursuant to ARS Section 42-6056, the Municipal Tax Hearing Officer is to hear all reviews of petitions for hearing or redetermination under the Model City Tax Code.

2. Section 100 defines "licensing for use" to be an agreement which does not qualify as a "sale" or "lease" or "rental agreement".

3. Section 100 defines "sale" as any transfer of title or possession, or both of property for a consideration.

4. Section 115 defines "computer software" to mean any computer program and custom software which is not "custom computer programming" is deemed to be tangible personal property, regardless of the method by which title, possession, or right to use the software is transferred to the user.

5. Based on the definitions set forth in Sections 100 and 115, Taxpayer's sale of its computer software was a sale of tangible personal property.

6. Section 100 provides it would be a "licensing for use" agreement if there was not

a sale, lease, or rental agreement. .

7. Since there was a sale, there is no "licensing for use" agreement.

8. Taxpayer's transactions were taxable pursuant to Section 460.

9. Out-of-City sales are exempt pursuant to Sections 100 and 465.

10. Taxpayer has demonstrated its sales were exempt out-of-City sales.

11. Section 542 provides that if the City adopts a new interpretation or application of any provision of this Chapter and the change or interpretation is not due to a change in the law, the change can only apply prospectively.

12. Taxpayer's March 13, 2009 protest should be granted.

ORDER

It is therefore ordered that the March 13, 2009 protest by ***Taxpayer*** of a tax assessment made by the City of Phoenix should be granted consistent with the Discussion, Findings, and Conclusions, herein.

It is further ordered that the City of Phoenix shall revise the assessment consistent with the Discussion, Findings, and Conclusions, herein.

It is further ordered that this Decision is effective immediately.

Municipal Tax Hearing Officer