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ARIZONA TAX RESEARCH ASSOCIATION

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Tax Court Rules PRTA Sales Tax Illegal

County Supervisors Vote 4-1 to Appeal

The Arizona Tax Court ruled in its July decision that the Pinal County transportation sales tax is illegal (*Harold Vangilder, et al. v. Arizona Department of Revenue, et al*). Specifically, the court stated that according to the county resolution adopted by the County Board of Supervisors (BOS), the half-cent sales tax approved by voters under Proposition 417 applies only to the retail classification, and "…failed to include 'each person' engaging in a taxable business, as required by the authorizing statute."

The Pinal County sales tax question to fund transportation projects was laced with procedural missteps from the beginning. The first mistake made by the BOS was when it adopted a resolution to put the half-cent sales tax on the 2017 general election ballot. Although the resolution stated the sales tax would apply to "every person engaging or continuing in the business of selling tangible personal property at retail," apparently that wasn't their intent.

Putting aside the question as to whether the "variable rate" language in statute permits the county to exempt the proposed tax on retail purchases exceeding $10,000, the county contends that it intended the tax to apply to all sales tax classifications, including prime contracting, utilities, bars and restaurants, and not just retail (See *ATRA January 2018 Newsletter*).

See PINAL APPEALS TAX RULING, Page 4

Digital Goods and Services: How Did We Get Here?

A proper debate on the taxation of digital goods and services demands an understanding of sales tax (transaction privilege tax, or TPT) laws in Arizona and how they might fit these new products. Fortunately, the government doesn't simply tax activities because they "seem like they should be taxable" or they are a close cousin of some other taxable activity. Sadly, this has been the policy foundation driving the Arizona Department of Revenue (ADOR) to date. Behind closed doors, you'll hear phrases like "Blockbuster was

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Inside: ***Wayfair*** **Decision Creates Challenges**

ATRA Golf Tournament:

Nov 2, 12:00 pm

Stonecreek GC

ATRA Outlook Conference:

Nov 15, 8:00 am

Embassy Suites Scottsdale

Contact the ATRA office to register

Wayfair Creates Challenges & Opportunity

As discussed in the ATRA June 2018 Newsletter, the United States Supreme Court in *Wayfair* overturned the long standing "physical presence" requirement for a remote seller to have nexus in a state and therefore be required to collect and remit sales tax to the state where the transaction was made. In overturning *Quill*, the SCOTUS returned the standard to an "economic presence" where a business is considered to have nexus if it conducts sufficient business in that state to warrant that state imposing the burden of complying with their tax laws. The court essentially validated the South Dakota model for establishing "economic nexus." While ATRA thinks this will end up being good for taxpayers in the long run, it appears the near future will be turbulent as state's grapple with the new rules.

Companies that sell goods and services to other states must remain particularly vigilant as states are adopting laws and rules nearly every week in response to *Wayfair*. In order to impose sales tax on remote sellers, legal experts generally agree the court established three concepts a state must first formulate:

1. There must be a clear delineation of what constitutes "substantial" nexus to protect small businesses from the burden of compliance. The court validated South Dakota's model of $100,000 in sales or 200 transactions in the current or previous year.
2. The application of the nexus law change must be prospective only and not used to assess back taxes.
3. The state must provide a taxation framework where compliance is not overly burdensome and complicated for the out-of-state seller to manage.

The third requirement quickly became legally contentious and states appear ready to draw their own interpretation. Kennedy's court ruling suggested South Dakota met this test by complying with the Streamlined Sales and Use Tax Agreement (SSUTA) which is a nationwide program several states are voluntarily adhering to in order to simplify and standardize sales taxes nationally by establishing common terms and rules. This effort greatly reduces the burden on a remote seller. However the court did not order that SSUTA membership be attained before establishing an economic nexus law, only that their economic nexus law not violate the Commerce Clause by being overly burdensome.

The 23 SSUTA member states have the safest legal pathway to begin taxing remote sellers. They simply adopt laws in compliance with steps 1 and 2 and they should face little interference. States with complex sales tax systems like Colorado, Arizona, Louisiana and Alabama have a tougher row to hoe.

Regrettably, the Court's guidance is having less impact in some states such as Louisiana, who has instituted economic nexus without simplifying their code or aligning to SSUTA. They claim they will simplify sometime in the future but will demand remote sellers collect immediately. Massachusetts declared remote sellers have nexus in their state based on using "cookie and app nexus" backdated to October 1, 2017, arguing the SCOTUS decision

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has no impact on their nexus laws. They too are not SSUTA members.

Lower courts won't be of much help either. Lawsuits against a state's interpretation of *Wayfair* must begin in state courts, which inevitably will lead to varying legal conclusions and thus disparate treatment around the nation. Though the business community has asked Congress to provide guidance, there appears little appetite to tackle such a complex issue in Washington.

Without Congressional input, there will be considerable chaos for the foreseeable future. Steve DelBianco of NetChoice outlined to Congress in July the myriad issues before them. Among them are sellers negotiating the thousands of taxing jurisdictions nationwide who can have different tax bases, variable rates, and different compliance rules. Though there are companies providing software so sellers can quickly identify the tax liability in their customer's location, it requires considerable human input. *"The most frequent error made by a seller is in 'mapping' their entire inventory of products and services to the categories used by each individual state and local jurisdiction across the country. For example, a seller may have coded his yeast products as 'food' instead of 'food items used in brewing.' A provider of online interactive training courses could code her courses as 'Digital Audio-Visual Works' or as "Online Training" service—which is taxable in only a handful of states."*

The most fundamental problem facing taxpayers is a lack of uniform definitions. The SSUTA has come a long way towards simplifying these headaches for taxpayers but membership remains low, even though states may still choose which items are in their taxable base.

The most complex hurdle is dealing with states like Arizona, whose definitions do not match SSUTA and has an independent municipal base, not codified in state statute, who choose their own base of taxable goods and definitions. In his decision, Kennedy explicitly called out these states: ***"…Complex state tax systems could have the effect of discriminating against interstate commerce. Concerns that complex state tax systems could be a burden on small business are answered in part by noting that, as discussed below, there are various plans already in place to simplify collection."*** Kennedy goes on to explain why the simplification efforts in SSUTA avoid commerce clause infringement.

This provides a win-win opportunity for both taxpayers and government. Extending tax to remote sellers will benefit state and local government coffers and create an even playing field for Main Street businesses while necessary simplification efforts can improve compliance for all taxpayers.

Other complications exist such as rate caps based on value. For example, the City of Phoenix has an additional 0.3% sales tax on just the first $10,000 of each sale. Some states have "sales tax holidays" where on one or two days a year there is no sales tax owed. Audit rules, payment schedules, exemption procedures, and a host of other intricacies further complicate matters.

In order to require remote sellers collect Arizona TPT, state lawmakers will have to address all three pillars established in *Wayfair* in law. This provides a win-win opportunity for both taxpayers and government. Extending tax to remote sellers will benefit state and local government coffers and create an even playing field for Main Street businesses while necessary simplification efforts can improve compliance for all taxpayers.

-Sean McCarthy

Pinal Appeals Tax Ruling, *Continued from Page 1*

In a July 2017 op-ed questioning the legality of the tax, ATRA correctly reported that the county resolution adopted by the BOS stated the proposed sales tax would apply only to retail purchases. If the county had not known of their error prior to that time, there was still ample time for the BOS to adopt another resolution to correct their error. For whatever reason, they did nothing.

The information pamphlet subsequently mailed to voters in August specified the tax would apply to all classifications, which was in direct conflict with the county resolution. In that same document, the text of the ballot question to voters stated the tax would apply only to retail.

In September 2017, the BOS was informed once more regarding the conflicting language, this time in a letter authored by Tim Sandefur, legal counsel for the Goldwater Institute. In that letter, Sandefur outlined the contradictory language between the county resolution and the publicity pamphlet and requested the BOS remove the question from the ballot until a new resolution is adopted that "is properly and accurately publicized by the County administrators," otherwise the county may be subject to litigation. Once again, county officials took no action. Prop 417 was subsequently approved at the 2017 general election ballot, but it's uncertain if voters knew exactly what they were voting for– a new tax on retail purchases only or a new tax on all sales tax activity.

True to its word, the Goldwater Institute filed a lawsuit in Tax Court in December to challenge the questionable tax. Despite efforts to delay imposition of the tax, Pinal County officials directed the Arizona Department of Revenue to begin collecting the tax effective April 1, 2018.

Regrettably, the Pinal BOS voted to appeal the decision within days after the Tax Court decision was published. The taxpayers of Pinal County would be best served if the county went back and presented voters with an initiative that aligns with state statute rather than appeal the Court's decision which could take years to decide. It's unclear at this time whether the county will request a stay of the decision to allow the county to continue collecting the tax. If it does and the county ultimately loses the appeal, further collections will increase the amounts Pinal County will be required to refund taxpayers it illegally collected.

-Jennifer Stielow

DIGITAL GOODS PRIMER, *Continued from Page 1*

taxable, why shouldn't Hulu be taxable?" Publicly, ADOR is on record suggesting they first look to the crux of the activity to see if something is taxable… then they apply the law, which of course, is not how the law works.

One must first understand that the exchange of money for something is not subject to TPT unless specifically taxable in law, though The League of Arizona Cities and Towns suggested just the opposite at the Legislature. The activity must first fall into a taxable classification, such as restaurant, utilities, or lodging. Once the classification is legally established, the laws governing that classification apply. To wit, digital goods have been taxed by ADOR under both the retail sale and lease of tangible personal property (TPP).

ADOR's first legal hurdle is to establish that digital goods are "personal" property. This was more easily understood when users purchased physical disks from stores and took ownership of software licenses. As such, when ADOR instituted a rule in 1993 (TPR 93-48) that software sold at retail would be considered TPP, concerns did not yet flare. However, this is not how most states handled the situation.

Per A.R.S. § 42-5001 (17), "'Tangible personal property' is property that can be seen, weighed, measured, felt or touched or is in any other manner perceptible to the senses." This is often referred to as a "wide definition" which captures most goods sold or leased. It, however, first must be 'property' in its natural understanding. Software, which is a series of code which changes the way a user's hardware presents information, is difficult to understand as property, particularly when transferred electronically. If a transaction for "anything imaginable" could be the sale or lease of TPP, then why separate and discrete classifications for restaurants, lodging, or utilities, etc.?

States with similar "wide definitions" of TPP as Arizona amended their statutes to include software or explicitly taxed it in addition to TPP. This was because tax experts and courts agreed that software delivered electronically was not obviously understood as personal property. Though software can be measured, it is hardly "perceptible to the senses" on its own and it's dubious whether it is *personal* property as it can often be remotely disabled or rendered useless. **As such, states like Florida, California, and Virginia who have the exact same definition of TPP as Arizona, do not tax software and digital products as a general rule**. They await the action of their legislatures. In fact, there are just three states, all well known for undesirable sales tax systems, who tax electronically delivered software without an enabling law: Arizona, Alabama, and Louisiana.

Paul Mooney, one of the foremost tax attorneys in Arizona, pointed out to the Legislature in a March 2018 letter that in addition to there being no law making software taxable, *"no Arizona case has ever held that these services, which are provided under various forms of agreements – almost always via the Internet – involve the sale or leasing "tangible" goods... in fact, the only existing Arizona tax law on that issue holds the exact opposite. Honeywell Information Systems v. Maricopa County, 118 Ariz. 171, 173 (Ct App. 1978) ("There is little doubt that computer software is intangible equipment.") And, while the Honeywell case is a case involving Arizona's property tax laws, it holds that software is a non-taxable intangible that is not subject to Arizona's property tax on the value of tangible real and personal property."*

If it were easily presumable that software could be taxed like retail goods, it hardly follows that states around the country would have expended considerable energy to update their laws to make software taxable. For example, of the 18 states with a similar "wide" definition of TPP as Arizona, most including Connecticut, Michigan, Mississippi, New Jersey, North Dakota, North Carolina, Rhode Island, South Dakota, Texas, Vermont, and Washington have amended their statutory definition of TPP to include "prewritten computer software" (or a similar term) or defined it to be taxed similarly to TPP. Arizona sits in a most uncomfortable position along with Alabama and Louisiana.

Examining the Jukebox Case

The one court case routinely cited by ADOR to justify their claim that all software is TPP is the "Jukebox" case in *State v. Jones, 60 Ariz. (1943)*, where the courts ruled that an audio jukebox owner must remit TPT on the gross proceeds of the jukebox. ADOR cites *State v. Jones* with this interpretation: "Consistent with the broad definition of tangible personal property, there is longstanding precedent in case law for that definition to be applied to things other than physical goods … such as music played from a jukebox." This 1943 court ruling provides little context to Arizona's present taxation authority. The crux of the transaction was a customer using a machine that plays music. At the time, there wasn't a "rental of TPP" classification in law. The clearest application of tax law in this fact situation is the rental of TPP, since the customer "rents" the jukebox, which is a machine that clearly is personal property. The fact that one can hear the music that is played does not change the fact that this piece of personal property has been rented for three to five minutes. The courts fit a square peg in a round hole when they claimed this was a retail sale of personal property. The Jukebox was not sold. The customer doesn't get to keep the song. How can it be a retail sale if the customer keeps no personal property? Using *State v. Jones* to guide the taxation of digital products today is half-baked. If this interpretation was truly the basis for understanding TPP, disc jockey (DJ) services would be made taxable because the party-thrower is paying for "music playing from a machine." However, DJ services are not subject to TPT because (among other reasons) the machines are not in control by the customer.

Breaking down Exclusive Use and Control

As if the state wasn't on enough shaky legal ground with its decision that all software is TPP without statutory language making it so, taxing subscription software and other digital products using the rental of TPP classification is where ADOR falls through the legal floor. In the Supreme Court decision *State Tax Commission v. Peck,* 476 *P.2d 849 (1970)*, the court established a threshold test that must be met for the rental of TPP to be imposed. The customer must have "exclusive use" of the personal property and maintain "exclusive control" over the use of that property. As such, the rental of a coin-op laundry was determined to be a rental of TPP and therefore is taxable. In 2002, the Arizona Court of Appeals ruled that a tanning salon did not meet the "exclusive use and control" test because while the customer did have exclusive use of the machine, salon staff maintained the machines during use and could take control at any time (*Energy Squared v. ADOR 56 P 3d 686 2002).* Ergo, tanning salons are not a rental of TPP but a service and not subject to TPT.

These rulings play a critical role in Arizona's understanding of its rental of personal property classification, forming the baseline in cases such as *Jones Outdoor v. ADOR* from 2015*,* where the Court of Appeals agreed that while an advertising billboard may involve personal property, the customer does not have any physical control over the billboards themselves, which are maintained by the billboard company who may alter them at any moment. They ruled in this case that this activity is better understood as advertising services, a tax which had been repealed by the Legislature in 1982. Consider then that ADOR is currently instructing companies who offer subscription software services, where the customer pays a fee for the right to manipulate a representation of said software on their device, that the transaction is a rental of personal property. In most cases the customer only has an agreement to view parts of the code the company allows them while maintaining full control of their software on their servers. Regardless of one's opinion over whether this activity should be made taxable, it is a massive legal leap to presume the rental class applies.

There are many states who have made electronically delivered software taxable by updating their state laws. Many of these states do not tax software-as-a-service (SaaS) and other subscription-based digital programs where the user does not receive a licensed copy of software but only accesses software over the internet for a fee. This is because there is a legal hurdle between the two concepts. Recognizing a software license as a product the state wishes to make subject to sales tax does not give the state the authority to tax SaaS and other digital products. If the user is not paying for something they receive permanently, or they do not retain control over the software in a rental or subscription environment, then the exchange does not fit into a taxable classification. This is not an immaterial argument. If simply accessing software is to be made taxable, then every single transaction on the internet would be subject to TPT. Every financial transaction like Venmo or PayPal, or paying for someone to create and host a website, or any number of services provided online would apply. Sixteen of the 33 states who have elected to tax licensed software delivered electronically have not wandered into the difficult space of taxing internet-accessed software like SaaS. Arizona appears to be the only state to have done so without so much as an agency rule.

The foundation for ADORs position on taxing cloud computing and internet-accessed software is conflating these products with coin-op laundries (in *Peck)* while pretending the exclusive use and control standards which made tanning salons a service (in *Energy Squared)* do not exist. The idea that these products are akin to coin-op laundries falls flat with an appropriate understanding of how digital products operate and the back-end support required to make them function. **There is no exclusive control: customers do not pay for a system where they will provide their own troubleshooting capacity; they pay for a product they presume is being maintained and updated by technicians.** And if the product is down for maintenance; there's nothing they can do but wait. Moreover there is no exclusive use: if one presumed the personal property being rented is the physical server itself or server space, one customer hardly uses it exclusively. Sadly, ADOR has wandered far from the courts guidance and now says a customer gains 'exclusive use' with a credentialed login, as though the manifestation of the product on the customer's own hardware is the "personal property" they've rented. They argue the company's back-end support and input is *de minimus* and therefore the customer has exclusive control over the product. They have even begun to use phraseology other states have adopted to stretch the understanding of the rental class, such as "sufficient control," knowing the meaning of "exclusive control" cannot be met. They argue cloud computing is simply a coin-op laundry and the input a salon technician has over a tanning bed is somehow considerably more than a digital company has over their product.

This mess cannot continue. Taxpayers deserve to have clarity on which products will be subject to tax and which will be viewed as nontaxable services. ADOR randomly auditing companies one at a time and insisting back taxes are owed despite no statutory or regulatory guidance is giving the state an awful reputation with digital companies. The Legislature must be consulted; the policy decisions are theirs to answer. Asking for forgiveness instead of permission is an awful way to construct tax policy. In the meantime, lawsuits against the state mount.

-Sean McCarthy

ATRA PRESS RELEASE

August 2018

Action without information is dangerous. Information without action is futile.

The State of Arizona recently responded to demands for higher teacher pay with a plan to increase base K-12 funding to provide a 20% teacher pay increase by the fall of 2020. ATRA analyzed Arizona teacher pay earlier this year, providing relevant facts and context to the policy issue. With this dramatic taxpayer investment, Arizona's relative teacher pay ranking shifts considerably. This release also highlights conclusions from our K-12 funding studies.

Arizona Teacher Pay Update

- 20% increase over 3 years jumps AZ average pay rank from #40 to #16
  - Using NEA data, AZ avg pay projects to ~$56,600
  - This is adjusted for cost of living (COLI), unadjusted rank would be #26
  - Assumes every other state grows pay 2% in each of the 3 years

What Are Arizona's K-12 Funding Challenges?

- Considerable decentralization of AZ's public school system
  - Declining/flat enrollment in most districts creates budget pressure
  - Massive growth in charters & open enrollment 'spread' the system
- Rising employee costs have limited pay raises
  - Total pension costs have increased 4X since early 2000's from 6% to 23%
  - Rising healthcare costs (example: State of AZ health plan up 21% since 2015)
- Rising costs of special education (SPED)
  - SPED population has outpaced overall student growth by a factor of four
  - Modern programs cost more than formula funds; costs placed on budget
- Demographic challenges (few taxpayers)
  - AZ ranks #49 in % population age 18-64 (Census Bureau, CB)
  - Only state ranking in top 15 for both % young & % old (CB)
- Wealth in Arizona per student
  - AZ ranks #45 in nation for total personal income per K-12 student (CB)
  - AZ ranks #19 for total K-12 spending per $1000 of personal income (NEA)

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