

CAVANAGH

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March 6, 2018

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VIA HAND DELIVERY

President Steve Yarbrough
Speaker J.D. Mesnard
Arizona State Legislature
1700 W. Washington
Phoenix, AZ 85007

Re: The March 1, 2018 fiscal note for SB 1392 is fundamentally flawed

Dear President Yarbrough and Speaker Mesnard,

I write to express some of my¹ concerns regarding the March 1, 2018 Fiscal Note that the JLBC prepared for SB 1392, the bill that would define which digital goods and services are subject to transaction privilege tax (“TPT”) in Arizona. While the JLBC opined that the bill would result in a loss to the General Fund, its opinion was based on faulty premises and it did not address the potential financial consequences of the alternative – namely, the state’s (and Arizona municipalities’ and counties’) exposure for TPT refunds. Worse yet, if the Legislature does not act now to define which digital goods and services are subject to TPT, the state may be unable to collect TPT on software and specified digital goods going forward should taxpayers’ refund challenges be successful.

BACKGROUND

As you know, the Ad Hoc Joint Committee on the Tax Treatment of Digital Goods and Services met over the summer and delivered its report shortly before this legislative session began. The Committee concluded that businesses, taxpayers, the Department of Revenue (“DOR”) and local taxing authorities *need* statutory direction regarding which digital goods and services are subject to TPT. We are in this unfortunate position because the DOR and local taxing authorities have been trying to apply 20th century tax laws to digital goods and services.

Despite the lack of clear statutory authority to support their position, the DOR and local taxing authorities have persuaded some businesses that deal in digital goods and services to begin collecting and reporting TPT from their customers as if they were engaged in the business of selling or renting tangible personal property. To make matters worse, when other taxpayers heard about isolated assessments of tax, penalties and interest in Arizona, some of them began voluntarily collecting and reporting the TPT from their customers as well rather than risk an assessment of their own.

¹ My practice has focused on Arizona state and local tax issues for over 22 years. Before going into private practice, I was the DOR’s Chief Auditor for transaction privilege taxes.

ANALYSIS

The Fiscal Note Is Based on Dubious Premises

The JLBC's March 1, 2018 Fiscal Note was based on faulty premises because it assumed that any TPT the state and its localities have collected on transactions involving digital goods and services was lawfully due. That assumption is dubious, at best, because:

1. Arizona imposes TPT on sales or rentals of tangible personal property. Digital goods and services are not tangible because they are not perceptible to the senses. One cannot see, hear, touch, feel, or taste a digital good or service. Most states that elected to tax software or digital goods updated their definition of tangible personal property or created a new class of taxable goods, and states like California that use the same definition of tangible personal property never have taxed digital goods and services.
2. Because companies generally provide digital goods and services under license agreements rather than sell them outright or lease them, transactions involving digital goods typically would not trigger Arizona's TPT, which only applies to transactions involving sales and rentals of tangible personal property -- and not to transactions involving licenses to use intellectual property, or to service transactions.
3. Arizona taxing authorities have persuaded some businesses to collect and report TPT from their customers even though the businesses do not have nexus with Arizona. Contrary to the JLBC's assertion in their Fiscal Note, it is not easier to establish nexus under the rental classification than it is under the retail classification because, according to the U.S. Supreme Court, nexus requires physical presence in the state. Digital goods and services are not tangible and, thus, the fact that a company's customers use them in the state does not create nexus for the company that owns the intellectual property rights for those digital goods and services. No other state has taken this expansive view of nexus or attempted to circumvent the physical presence standard without at least passing a law to set up a legal challenge to the standard.
4. Arizona's taxing authorities have persuaded some businesses to pay TPT on digital goods and services delivered over the internet that are not taxable when purchased through traditional channels, which is a violation of the federal Internet Tax Freedom Act. For instance, information technology, legal, accounting, and financial services are not subject to tax, but Arizona taxing authorities have attempted to tax them when they are delivered through an online platform.

Not Passing SB 1392 Could Cost the State Much More Than Passing SB 1392

While the JLBC opined that SB 1392 would result in a loss to the General Fund, it did not address the potential and substantial financial consequences of the alternative – that of the Legislature not acting to define which digital goods and services are subject to TPT. Because the DOR persuaded some businesses to begin collecting and reporting TPT on their proceeds from digital goods and services without clear legal authority to do so, the state will be in a perilous

legal position where it is exposed to potential TPT refund claims until the Legislature acts to clarify which digital goods and services are taxable.

Passing SB 1392 Will Stabilize Arizona Tax Collections on Digital Goods and Services

Because Arizona has not given *any* statutory direction to the business community, *many* businesses that deal in digital goods and services have not paid the taxes that DOR and the cities claim are lawfully due. Consequently, rather than result in a loss to the General Fund, passing SB 1392 should help stabilize the general fund by codifying that software and some of the digital goods that DOR claims are taxable are, in fact, taxable.

On the other hand, if SB 1392 is not enacted, it will only be a matter of time until taxpayers challenge Arizona taxing authorities' current positions related to the taxation of digital goods and services, and likely prevail. Because digital goods and services are not tangible, because they are not sold or rented in the way that tangible personal property is, because Arizona does not impose TPT on most services, and because Arizona taxing authorities persuaded some businesses to pay TPT on some digital goods and services delivered over the internet that are not taxable when purchased through traditional channels (in violation of the federal Internet Tax Freedom Act), Arizona and its local jurisdictions probably would lose those challenges under existing law.

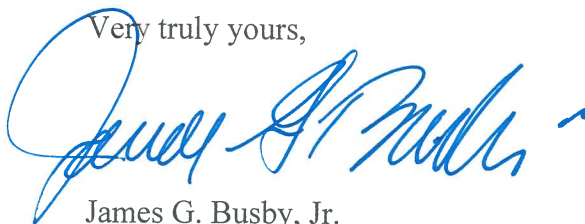
CONCLUSION

The Fiscal Note for SB 1392 is simply wrong. Rather than cost the state and its local jurisdictions money, passing SB 1392 will stabilize the state's ability to collect TPT on software and on specified digital goods by codifying what is and what is not taxable so that every business will be in a position to voluntarily comply with Arizona law. In addition, passing SB 1392 will help the state minimize its exposure for refunds by codifying what is taxable.

I kept this letter brief out of respect for your time because I know how busy you are. However, I understand that this area of the law is very complex and that it can be confusing. Accordingly, if you or your colleagues in the Senate would like to discuss this matter in further detail, I would be pleased to schedule a meeting with any or all of you.

Thank you for clarifying this important tax issue for Arizona citizens and businesses.

Very truly yours,

A handwritten signature in blue ink, appearing to read "James G. Busby, Jr.", with a stylized flourish at the end.

James G. Busby, Jr.
Senior Member

cc: Rep. Michelle Ugenti-Rita
Senator David C. Farnsworth