



Taxability of Digital Goods, Software and other Electronic items In Arizona

For: Ad Hoc Joint Committee on the Tax Treatment of Digital Goods and Services

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Agenda

- ADOR Mission, Vision, & High-level Summary
- Explain TPT and Model City Tax Code (MCTC) classifications relevant to software and digital goods
- Explain Arizona definition of Tangible Personal Property and its expansiveness relative to other states
- Explain authorities and analysis used to determine taxability of software, digital goods and other electronic items
- Provide examples of previous guidance, administrative decisions and settled cases
- Recommendations & Path Forward



Mission & Vision



OUR MISSION

Serving taxpayers!

OUR VISION

Funding Arizona's future through excellence in innovation, customer service and continuous improvement



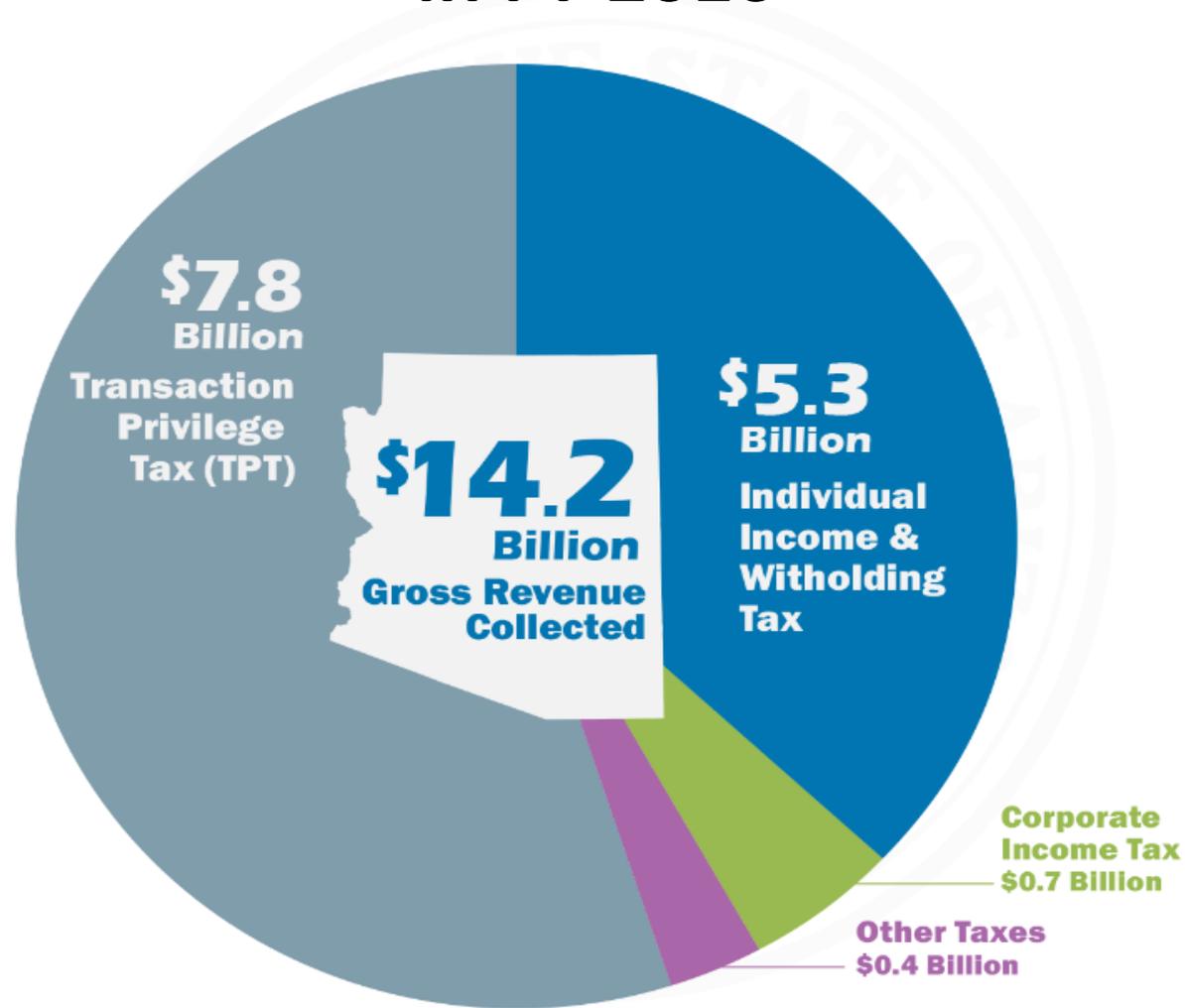
PURSUANT TO ARIZONA REVISED STATUTES (A.R.S.) TITLES 42 AND 43

FY17 ANNUAL OPERATING BUDGET

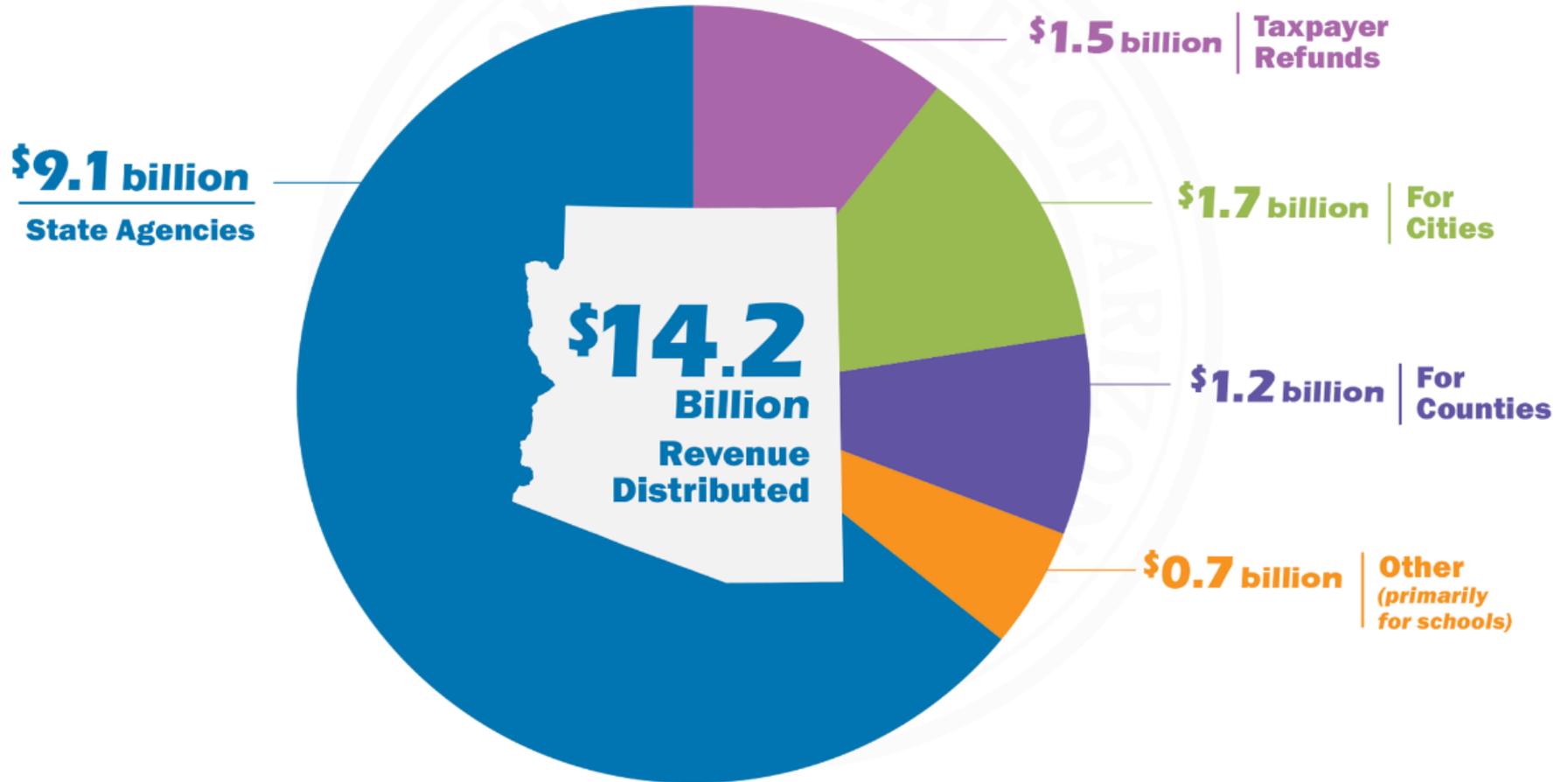
\$78.8 MILLION
531 Employees



Revenue collections exceeded \$14 billion in FY 2016



Revenue distributions primarily fund State operations, cities/towns, & counties



ADOR's multi-faceted operations touch every part of Arizona - FY16 Highlights

- **Nearly 5.9M Tax Returns Processed**
 - 1.7M+ Transaction Privilege Tax
 - 193,000+ corporate returns
 - 3.3M individual income tax returns
 - 2.1M individual income tax refunds
- **\$78.4 million in Individual Income Tax Fraud Stopped**
- **45,000 new TPT licenses issued**
- **\$54.9 million in Unclaimed Property Returned**
- **Property Tax Unit valued 963 Centrally Valued Properties & Trained 186 Certified County Appraisers**





Overview of Transaction Privilege Tax and its Applicability to Digital Goods

Arizona Transaction Privilege Tax (TPT) General Overview

- **Tax on the privilege of conducting business in Arizona**
 - Seller or vendor taxable
 - Seller may pass economic expense to purchaser
- **Generally all of a business' gross income within one or more of 16 business classifications is taxable unless specific exemption or deduction exists**
- **Exemptions or deductions only available for the specific classification under which the deduction is provided**
 - Deduction under one classification does not apply under another classification unless specifically provided
- **Tax Statutes are construed strictly against a party who claims an exemption**

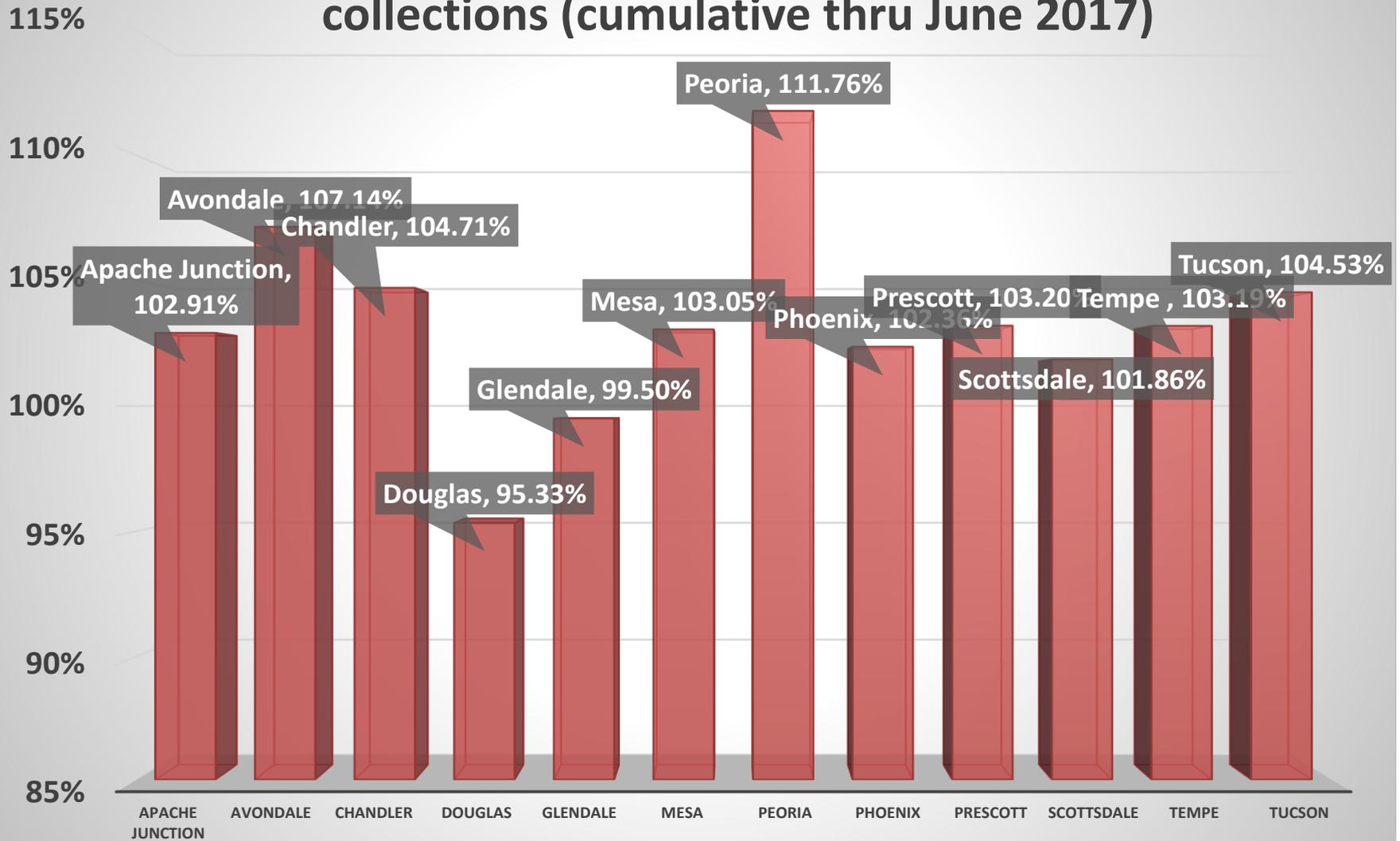


Privilege Taxes & the Model City Tax Code (MCTC)

- **Municipalities determine own privilege tax base under the MCTC.**
 - Have many of the same business classifications as found in State Statute
 - Personal property rental classification is broader than State Statute – MCTC includes licensing of personal property
- **Municipal Tax Code Commission determines changes to MCTC.**
 - *local options*
 - *model options*
- **Municipalities determine own rates.**
 - *low of 1%*
 - *high of 6%*
- **Arizona Department of Revenue (ADOR) is the single point of administration for State, County, and Municipal Privilege Tax**



DOR's 2017 collections exceeding 2016 cities' collections (cumulative thru June 2017)



TPT Classifications & Digital Goods

- Currently 16 different classifications
- For software and digital goods only two classes are generally implicated:

Retail



**Rental of Tangible
Personal Property**



Rental Classification

(A.R.S. § 42-5071 and MCTC §450)

- **Tax on gross income derived from the lease of TPP**
 - Normally ongoing periodic fees collected for use of TPP
 - Non-payment of fees usually means discontinued use
 - Lessee normally has exclusive use and control over TPP
 - Services not *excluded* where connected to lease even if separately stated (e.g.. installation and delivery charges) unless a separate line of business exists (A.C.C. R15-5-1502).
 - *MCTC exempts separately billed delivery, installation, repair and/or maintenance charges.*



Tangible Personal Property Defined

- **What is TPP?**

- Defined as “personal property which may ***be seen, weighed, measured, felt or touched or is in any other manner perceptible to the senses.***” A.R.S. § 42-5001(17).

- *Very Broad*

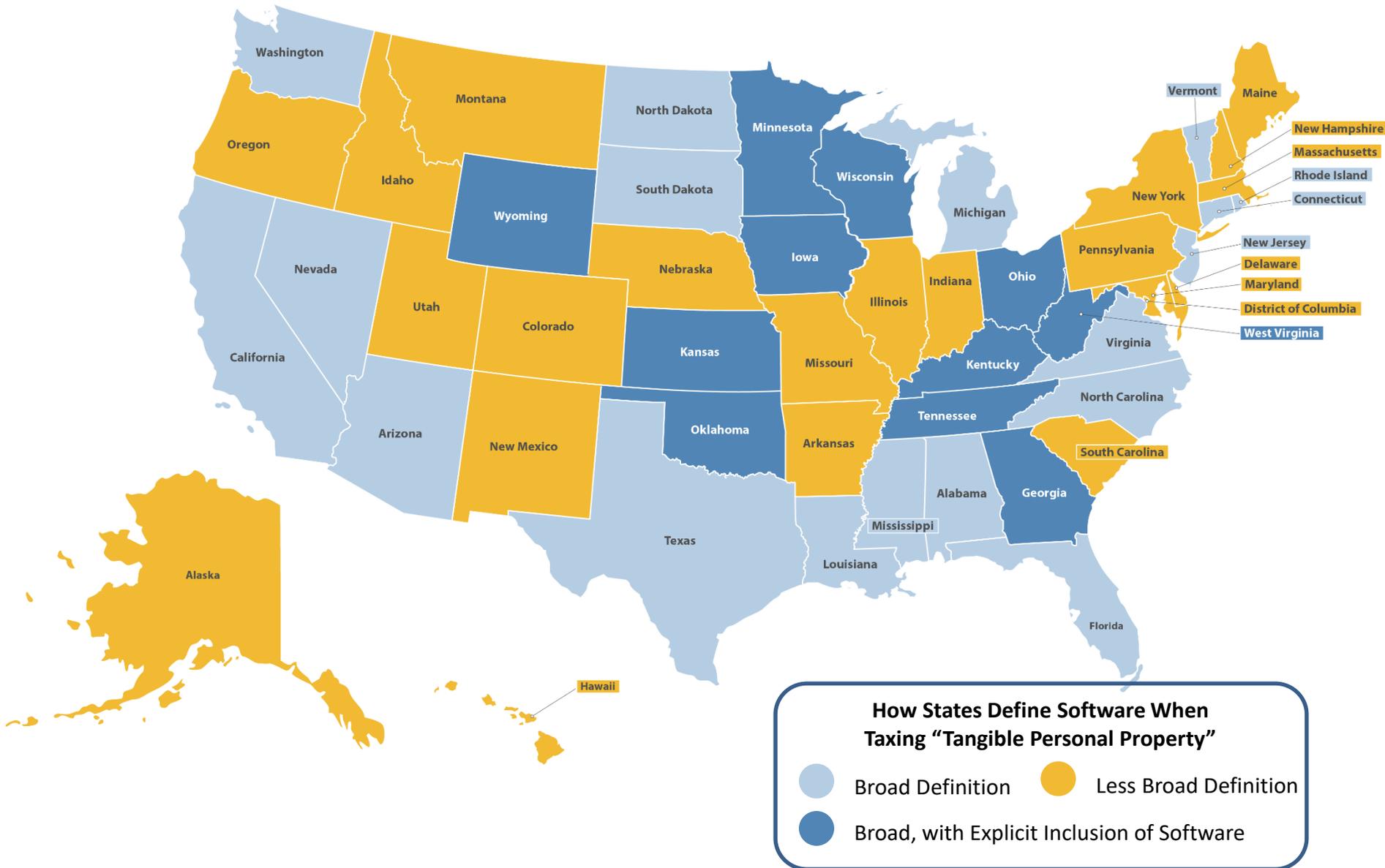
- *Obvious examples:*

- Paper, pens, computers, CDs, DVDs etc.

- MCTC does not define tangible personal property.



17 States have definition of TPP as broad as Arizona, and another 11 explicitly include software in its broad TPP definition





Does software and other digital goods meet the definition of TPP?

Does TPP include software & other digital goods?

- ADOR analysis based on statutory definition of TPP and case law
- Broad statutory definition includes things *other than* physical goods
 - Music played from a jukebox (*State v. Jones, 60 Ariz. 412 (1943)*)
- Arizona case law *suggests* it is TPP
 - Software considered machinery and equipment (“M&E”) used in manufacturing (*Southwest Airlines Co. v. AZ DOR, 237 Ariz. 50 (2015)*)
- Based on above, the Department has concluded that it does
- Nevertheless, no Arizona statutes or cases definitive on the issue



Authorities that Determine Taxability of Electronic Goods – Retail Classification

- **Generally, authoritative guidance distinguishes between services in addition to the sale of TPP. Examples include:**
 - A.A.C. R15-5-154 (Administrative rules have force and effect of law/statute)
 - *Sale of canned computer software taxable regardless of method used for delivery*
 - *Services rendered in addition to sale not taxable*
 - MCTC Reg. 115.1 addresses computer hardware, software and data services
 - ADOR Transaction Privilege Tax Ruling (TPR) 93-48
 - *the sale of canned or pre-written software taxable under retail classification;*
 - *custom software not taxable (treated as sale of professional service)*



Other Authorities that Determine Taxability of Electronic Goods – Retail Classification

- A.A.C. R15-5-105
 - *Receipts from services rendered in addition to selling TPP subject to tax unless separately stated on receipt and in records*
- ADOR Transaction Privilege Tax Ruling (TPR) 93-31
 - *Exempt services may be excluded from tax base if separately stated*
- ADOR Transaction Privilege Tax Ruling (TPR) 90-2
 - *In service businesses, services generally geared towards specific needs of specific customer*
 - *Final product which may or may not take tangible form is geared toward specific customer*



Dominant Purpose Test in distinguishing taxable TPP vs. non-taxable services - Retail Classification

- If the dominant purpose or true object of a transaction is a service, then the transaction is *not* taxable: (*Goodyear Aircraft Corp. v. Arizona State Tax Commissioner, 1 Ariz. App. 302 (1965)*)
- Factors generally considered to determine whether the dominant purpose of a transaction is TPP or a service
 - *Can a customer purchase the service without purchasing TPP?*
 - *Is the activity geared toward a specific customer and its needs?*
 - *Is any TPP created by Taxpayer as a result of the services performed for the specific customer (e.g. lawyer creating will, accountant creating tax return)?*
 - *Is the customer seeking out expertise in an area normally considered the provision of professional services?*
 - *Does invoice suggest what is purchased is a service rather than TPP?*



Authorities that Determine Taxability of Electronic Goods – Rental Classification

- Rentals of digital goods usually implicated when:
 - Customer pays periodic fee to use the software or other electronic good
 - At end of rental period, customer stops paying fee and discontinues use of software or access to the electronic item is denied



Authorities that Determine Taxability of Electronic Goods – Rental Classification

- **A.C.C. R15-5-1502**
 - Services in relation to the lease of TPP is included in the tax base whether or not separately stated (this is a major distinction in treatment between retail and rentals)
- ***State Tax Commission v. Peck, 106 Ariz. 394 (1970)***
 - *Adopted a dictionary meaning of “rental”*
 - *Exclusive use and control of TPP by customer is required*



Authorities that Determine Taxability of Electronic Goods – Rental Classification

- **Energy Squared v. Arizona Department of Revenue, 203 Ariz. 507 (2002)**
 - No exclusive control found based on specific facts; it was a non-taxable service where TPP was used in performing service
 - *Tanning beds controlled by technician who determined*
 - Whether to commence session
 - How long session lasted
- **Phoenix v. Bentley–Dille Gradall Rentals, Inc, 136 Ariz. 289 (1983)**
 - Providing equipment with an operator to a customer not taxable since taxpayer did not give up possession or control





**Other factors that guide ADOR's
analysis, including sourcing**

Other Factors that Determine Taxability of Digital Goods

- Additionally, other factors are considered to determine whether activity is a sale, a rental, or non-taxable.
- **Factors for taxing** include:
 - Software downloaded to a computer;
 - Software generally used by all customers;
 - Customer uses software without assistance of taxpayer and can enter its own data and manipulate the software functions to run reports, etc.
 - Taxpayer only provides technical support to customers to assist with its use of the software; other than technical support virtually no other element of personal services provided



Additional factors for treating an economic event as a taxable digital good

- Taxpayer's income primarily derived from software/digital goods as opposed to other services it provides
- The customer can only obtain the taxpayer's services if it purchases the software/digital goods, and the services are billed with the software/digital goods as one price
- The taxpayer is normally in the business of providing software/digital goods to its customers
- The customer has control of the software/digital goods



Factors Against Treating an Economic Activity as a Taxable Digital Good

- Software created for a specific customer.
- Taxpayer uses software for the benefit of its customer and uses information from the customer in the use of the software. (e.g. the taxpayer provides information to the customer based on the customer's input).
- The taxpayer is normally engaged in a service business, but is using software to more efficiently deliver that service.
- Customer can use/pay for taxpayer's services without purchasing software.
- Other elements of personal services provided by taxpayer.
- Taxpayer has control of the software or shares control of the software with the customer.



Other Analytical Factors at Play

- Is there a contract? What does it say? Is there any difference between what the contract says and what occurs in practice?
- Is price for service and software separately stated on the invoice and on the taxpayer's books and records?
- What is the basis of payment? Is there a one-time fee or are payments ongoing?
- If payments are ongoing, what happens if the customer stops paying the fee?



Guidance For Determining Taxability of Electronic Goods - Sourcing

- Once an activity is deemed taxable, the taxable income must be sourced to a specific jurisdiction
- **Retail**
 - Sales of tangible personal property are sourced to the **seller's location** if the seller received the order at a business location in Arizona
 - To the **purchaser's location** in Arizona where the seller receives the order at a business location outside Arizona (A.R.S. § 42-5040)
- **Rental**
 - Gross income sourced to lessor's business location if lessor has a business location in Arizona and to lessee's address in Arizona if lessor does not have a business location in Arizona;
 - Gross income taxable when property is shipped, delivered, or brought into Arizona for use in Arizona. (A.R.S. § 42-5040, A.C.C. R15-5-1503)



Guidance For Determining Taxability of Electronic Goods

- **The Department analyzes software and digital goods no differently than other forms of TPP.**
 - Downloaded software and other digital or electronic items treated as taxable as if they were purchased from a brick-and-mortar retailer
 - Where no service included, only issue is whether there is a lease or sale of TPP;
 - When services involved, the issue is the extent to which such services played a role in the transaction
- **Goal is to attain equitable treatment for all types of economic activity, regardless of the delivery method (physical vs. digital). User experience is key.**





Tax Analysis Examples in the Digital Goods Space

Digital Goods Questions/Analysis

Example #1

- **Arizona Private Taxpayer Ruling 02-21 & 02-022.**
 - Electronic program guides, specialized electronic television viewing guides, and programming content specifically created by Taxpayer constituted *information services* and were *not taxable*.
 - Software updates taxable as retail sales.
 - If not separately stated, the entire amount for both is taxable.



Digital Goods Questions/Analysis

Example #2

- **Arizona Private Taxpayer Ruling 95-010.**
 - Licensing of software *taxable* sale of TPP regardless of the method of transmittal
 - *Software enabled high volume paper scanning and a multimedia presentation package that allowed users to present scanned documents, photos, charts, slides etc.*



Digital Goods Questions/Analysis

Example #3

- **Arizona Private Taxpayer Ruling 04-010.**
 - Gross income derived from software license leased to Arizona customers taxable when the software stored outside Arizona, but used in Arizona by customer.
 - Fees from extranet hosting taxable if service is directly related to the software lease.
 - Such service not taxable as professional service if not related to any software lease or rental by Taxpayer.



Digital Goods Questions/Analysis

Example #4

- **Arizona Private Taxpayer Ruling 05-008.**
 - Sale of real-time tracking software used to operate device was taxable retail sale.
 - Activation fees and subscription fees not taxable as service in addition to sale of tangible personal property.
 - Rental of tracking device taxable as lease; activation fees and subscription fees also included as part of taxable rental income.



Digital Goods Questions/Analysis

Example #5

- **Arizona Private Taxpayer Ruling 07-006.**
 - Gross receipts derived from *hosting* software for client *not taxable* under retail classification. However, licensing of software *taxable*.
 - *Hosting included:*
 - access to taxpayer's computer network,
 - ability to store and retrieve data on taxpayer's computer network
 - data backup and file maintenance.



Digital Goods Questions/Analysis

Example #6

- **Arizona Private Taxpayer Ruling 08-006.**
 - Internet membership club offering coupons, discounts, identity theft protection, credit monitoring and newsletters for a monthly fee *not taxable*.
 - Arizona does not tax the sale of advertising



Digital Goods Questions/Analysis

Example #7

- **Arizona Private Taxpayer Ruling 12-003.**
 - Site Fees covering access to website *taxable* as rental of tangible personal property when collected from Arizona customers.
 - Fees included:
 - *computer simulation programs,*
 - *virtual environments from third-party vendors,*
 - *access to virtual organizations (e.g., computer labs), tutorial services in math and writing, and*
 - *library content that enabled students to access multiple research databases*



Digital Goods Questions/Analysis

Example #8

- **Arizona Private Taxpayer Ruling 15-001.**
 - Business providing electronic backup, storage and retrieval (i.e. *hosting*) of its customer's content and data on its network through the use of specific software that required the customer to download interface software to establish a connection *taxable*.
 - *Software performed backup functions automatically*
 - *Files deleted from taxpayer's server once customer no longer required it or stopped paying the fees.*
 - *No services other than technical support performed by taxpayer (those services were inconsequential)*
 - *Customers themselves were able to operate the backup software, albeit remotely.*



Director's Decisions and Settled Cases

- **Director's Decision 201400197-S (10/27/15)**
 - Subscription income from online database was subject to transaction privilege tax under the state and city personal property rental classifications.
 - Taxpayer's customers had sufficient use and control when accessing and manipulating the Taxpayer's online database to qualify as rental under the personal property rental classification
 - This case was ultimately resolved through a closing agreement
- **Settled cases**
 - There are no other settled cases to reference at this time but there are cases currently in the Administrative Appeal process.



Role for Public Policy Input

- **More public guidelines required to provide clarity for taxpayers and address increasingly complex situations**
 - Most ADOR issued guidance is in the form of private letter rulings that are specific to a taxpayer requesting it; cannot be relied on by other taxpayers
 - Business structures and types of products offered becoming more complex and difficult to categorize
 - **SaaS** (*customers using provider's applications on cloud infrastructure,*)
 - **PaaS** (*customers deploy their own software using provider's programming languages, libraries, services etc.),*
 - **IaaS** (*customers access provider's processing, storage, networks and other computing resources and deploy their own operating system) models difficult to analyze with existing framework.*



Other Areas of Need: Remote Access

- **Remote Access situations – Sourcing**
 - Retail sales -sourced to location of business if order received in Arizona and to customer’s location where order received outside Arizona
 - Rentals - Unclear how sourcing should be handled for rentals where remote access implicated
 - *gross receipts “taxable when ...property is shipped, delivered, or otherwise brought into the state for use in in this state” (A.R.S. § 42-5040(C)(2))*
 - Suggests property must be in Arizona to be taxable as rental



Functionality or Code driven analysis?

- Remote Access situations – control over functionality or code?
 - Retail is generally clear - all ownership in the property is vested in the purchaser who may do whatever he/she wishes with the software or digital good
 - Rental is problematic – customer must have exclusive possession or control over the TPP
 - Is control over functionality or code?
 - *Department has focused on control over functionality and being able to use software as if downloaded*
 - *Whether sufficient “possession, use and control” can be exercised over TPP in remote access situations*



Competitive Environment & Fiscal Impact of tax law changes must be carefully considered

- Tax policy changes tend to create winners & losers among businesses
- General Fund revenue affected by changes to TPT
- Nature of TPT makes estimating revenue changes extremely challenging
 - Tax imposed on Gross Income, not on individual transactions
 - Information asymmetry between potential beneficiaries of tax law changes & estimators of revenue impacts
 - Revenue impacts can be significant and unanticipated
- Recommend that any proposed exemptions should be capped at an acceptable \$ amount, and conditionally repealed if cost of exemption exceeds acceptable \$ amount.



Where to from here?

- Create broad policy statement of taxable and non-taxable activities, taking into account current landscape of software and digital goods offerings and existing authorities.
- “Count the Cost” of recommended changes.
- If necessary, amend statutes (including statutes dealing with municipal taxes) to reflect policy and provide clarity to taxpayers.





THANK YOU!