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Governor

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Director

TAXPAYER INFORMATION RULING LR15-005

May 14, 2015

Thank you for your letter dated September 3, 2014 requesting a taxpayer information ruling ("TIR") on behalf of your *** client ("***" or "***"). Specifically, you requested a ruling regarding the applicability of the Arizona transaction privilege tax ("TPT") on *** website business. Pursuant to Arizona Revised Statutes (A.R.S.) § 42-2101, the Department may issue taxpayer information rulings ("TIR") to taxpayers and potential taxpayers on request.

ISSUE:

To determine whether *** gross receipts derived from its business of hosting websites which are created by its customers through the use of A's software under various plans and options are subject to Arizona's TPT under the personal property rental classification, the following issue must be addressed:

Whether by creating their own websites using software tools available to them *** customers gain sufficient control and possession of the software to constitute the rental of tangible personal property

RULING:

Based on the facts and documents provided the Department rules as follows:

Customers gain sufficient control and possession of the software tools on *** website to constitute constructive possession. At each level, the customer is able to customize what it needs based on its level of sophistication by manipulating the software available on *** website. Therefore, its customers manipulate its software so that they have possession and control to constitute a rental within the meaning of the personal property rental classification. Thus, the monthly gross receipts or gross income *** receives from its customers under Plans 2, 3, and 4 which offers its customers the ability to create their own websites through the use of progressively sophisticated software tools on *** website are taxable under the personal property rental classification when those monthly gross receipts are received from Arizona customers.

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Additionally, *** tax base includes all other fees and charges associated with the rental of tangible personal property. In addition to fees collected under Plans 2, 3 and 4, the following fees collected by *** are also included in its tax base under the personal property rental classification:

- Processing fees under Plan 1
- Charges for third party applications
- Charges for digital stock photography

Revenues from domain name registration fees are also included in *** tax base as well because it cannot establish that those fees were derived from a separate line of business.

SUMMARY OF FACTS:

*** is *** corporation primarily engaged in a website creation and hosting business that allows its users to create their own websites for free or for a charge. *** website offers photos, texts, maps and videos that allow users to create their own unique website by dragging and dropping items into place. *** maintains *** that focuses on providing customer support via phone to its current and potential customers. *** In addition to website creation and hosting, *** also offers other options including domain name registration, blogging, e-commerce, unlimited storage of information, e-mail and advertising. These options are offered in the following packages:

Plan 1: Users can create their own individualized website for free. This plan includes free website hosting. In addition, *** also offers its customers the option of being able to set up electronic payment processors if their website sells merchandise. Under this option, *** customers do not have to engage their own payment processors. *** pays processing fees on behalf of its customers to Paypal, Stripe etc. for each transaction processed on its customer's website and its customer reimburses the processing fees to it, plus a premium.

Plan 2: For a fee, users can connect their domain, receive expanded site statistics, and receive premium customer support in addition to what is already offered under Plan 1.

Plan 3: For a monthly fee, more sophisticated users receive professional multimedia features, powerful site search features, and password protection in addition to what is already offered under Plan 1 and Plan 2.

Plan 4: For a monthly fee users receive fully integrated e-commerce solutions, including a fully integrated shopping cart and secure checkout on their website, a complete mobile store and checkout process, the ability to sell digital goods and physical products or

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services on their website. They also receive a search engine optimized for online stores, the ability to track inventory and the ability to manage e-commerce on the go through a phone application in addition to what is already offered under Plans 1, 2 and 3. Charges for each of the plans are separately stated on *** invoices.

Other Options: In addition to the above plans, *** provides professional web designers a platform that allows them to create websites for their customers under their own labels. The designers are charged a flat monthly fee on a per website published basis. The monthly fee is due only when a website is published and handed over to its final user; the monthly fee is not charged while the website is being designed.

*** also resells third party applications and digital stock photography to its customers for a fee. The third party applications are created by outside developers that allow *** customers access to services through mobile devices. These applications are available to *** customers regardless of what plan they are using. Finally, *** buys and resells domain names to its customers. Charges for these other options are separately stated on *** invoices.

*** does not issue licenses for any of the software offered on its website, rather, it provides its customers with online access to the software.

*** receives the majority of its gross income from Plans 2, 3 and 4; it also receives significant income from domain name sales. *** receives only inconsequential revenue from other the options including the processing fees (under Plan 1), fees for third party applications and sale revenues from digital stock photography. *** does not specifically identify in its books how much of its revenue is generated by the plans or by the other options.

DISCUSSION & LEGAL ANALYSIS:

*** offers online access to software through which its customers can create websites by selecting one of a number of optional plans. *** also allows professionals to create their own websites for their own customers. Additionally, it offers all its customers, regardless of what plan they chose, options to purchase third party applications and digital stock photography. Apart from Plan 1 which is free to customers, *** customers are charged a monthly fee to create their own websites using its software. Whether *** gross income derived from its monthly fees is taxable for TPT purposes is dependent on whether those fees are primarily derived from the rental of tangible personal property.

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Consistent with the broad definition of tangible personal property as provided in A.R.S. § 42-5001(17),¹ there is longstanding precedent in case law for that definition to be applied to subjects other than physical goods, such as electricity, electronic delivery of software, and music played from a jukebox.² The Arizona Supreme Court's decision in *State v. Jones*³ addressed the scope of the taxation of tangible personal property. There, it held that when a person inserts a coin into a jukebox and listens to a phonograph record, he is purchasing tangible personal property; the playing of the record is perceptible to the sense of hearing and, hence, constitutes tangible personal property under the statute.

Significantly, in applying the broad definition of tangible personal property, numerous courts have concluded that software is tangible personal property and subject to tax.⁴ In *Wal-Mart Stores, Inc. v. City of Mobile*,⁵ the court held software was tangible personal property noting :⁶

The software itself, i.e., the physical copy, is not merely a right or an idea to be comprehended by the understanding. The purchaser of the computer software neither desires nor receives mere knowledge, but rather receives a certain arrangement of matter that will make his or her computer perform a desired function. This arrangement of matter, physically recorded on some tangible medium, constitutes a corporeal body.

Because software is normally recorded on some physical medium, whether it is located remotely on servers, downloaded on to a local network or delivered as hardware, it is

¹ A.R.S. § 42-5001(17) defines "tangible personal property" as "personal property which may be seen, weighed, measured, felt or touched or is in any other manner perceptible to the senses."

² *State Tax Comm'n v. Marcus J. Lawrence Mem. Hosp.*, 108 Ariz. 198, 495 P.2d 129 (1972) (en banc); *State v. Jones*, 60 Ariz. 412, 137 P.2d 970 (1943).

³ *Jones*, 60 Ariz. at 415, 137 P.2d at 971.

⁴ See, e.g., *Comshare, Inc. v. United States*, 27 F.3d 1142 (6th Cir.1994) (income tax credit); *Wal-Mart Stores, Inc. v. City of Mobile*, 696 So.2d 290 (Ala.1996) (sales tax); *Andrew Jergens Co. v. Wilkins*, 109 Ohio St.3d 396, 848 N.E.2d 499 (2006) (property tax); Ruhama Dankner Goldman, Comment, From Gaius to Gates: Can Civilian Concepts Survive the Age of Technology?, 42 Loy. L.Rev. 147, 158 (1996) ("the trend in classification of computer software has been to classify it as tangible personal property").

⁵ 696 So.2d 290 (Ala.1996)

⁶ *Walmart*, 696 So. 2d at 291, citing *South Cent. Bell Tel. Co. v. Barthelemy*, 643 So.2d 1240, 1244-45 (La.1994).

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tangible personal property. Thus, software is generally accepted to be tangible personal property, and in this case, the software offered on *** website is tangible personal property for TPT purposes.

A.R.S. § 42-5071 imposes TPT on the business of leasing or renting tangible personal property for a consideration. The tax base for the personal property rental classification is the gross proceeds of sales or gross income derived from the business. The tax base for this classification includes all fees and charges associated with the rental of tangible personal property and is not limited to only those charges identified as “rent.” The Arizona Administrative Code (“A.A.C.”) R15-5-1502(D) specifically provides that:

Gross income from the rental of tangible personal property includes charges for installation, labor, insurance, maintenance, repairs, pick-up, delivery, assembly, set-up, personal property taxes, and penalty fees even if these charges are billed as separate items, unless a specific statutory exemption, exclusion, or deduction applies.

The Arizona Supreme Court in *State Tax Commission v. Peck*,⁷ set out guidelines for determining whether a particular activity is considered personal property rental. *Peck* considered whether the business of coin-operated self-service laundries and car washes constituted leasing or renting tangible personal property for a consideration. To resolve this issue, the *Peck* court adopted a dictionary definition of the verb “to rent”. It noted:

Webster's Third International Dictionary defines the verb “to rent” as “(1) to take and hold under an agreement to pay rent,” or “(2) to obtain the possession and use of a place or article for rent.”⁸

The court determined that:

There is no question that when customers use the equipment on the premises of the plaintiffs herein, such customers have an exclusive use of the equipment for a fixed period of time and for payment of a fixed amount of money. It is also true that the customers themselves exclusively control all manual operations necessary to run the machines. In our view such

⁷ 106 Ariz. 394, 476 P.2d 849

⁸ *Id.* at 396, 476 P.2d at 851.

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exclusive use and control comes within the meaning of the term “renting” as used in the statute.⁹

The pivotal question, then, is whether *** customers gain sufficient control and use of its software to constitute the rental of tangible personal property. The granting or non-granting of a software license is not definitive of that question because a software license is dissimilar to other arrangements that fall under the general license nomenclature used for leases and rentals of tangible personal property. Virtually all sales of prewritten software are sales of nonexclusive rights to use, regardless of whether the software is sold on physical media or transmitted electronically or whether they have perpetual or limited terms. In addition, whether a customer is able to download the software is not definitive. The *Peck* Court noted:

we do not believe that the terms “leasing” or renting as used in the statute require that property so leased or rented be physically capable of being transported from one place to another by a customer. Nor do we believe that the mere attachment of a label such as “license” borrowed from other areas of law, can be dispositive of the tax question before us.¹⁰

As noted in *Peck*, actual possession of the property is not essential for a finding of control. Constructive possession is sufficient. Constructive possession may be established through a level of use that establishes the user’s possession of the software.

Manipulation of software can establish its constructive possession. Manipulation of software does not require that a user have access to its source code or the ability to change it. In addition, the type of manipulation required depends on the type of software involved. For example, word processing software would require a user to manipulate it by typing; database software is manipulated by requiring a user to enter their search parameters. Thus, the manipulation required for specific software is likely consistent with the way it is typically.

In this case ***, offers its customers the ability to set up their own website by giving them access to progressively more sophisticated software tools. Its customers have the option of creating a simple static website or one with fully functioning e-commerce tools. At each level, the customer is able to customize what it needs based on its level of sophistication by manipulating the software available on *** website. *** offers its customers technical

⁹ *Id.*

¹⁰ *Peck*, 106 Ariz. at 396; 476 P.2d at 851.

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support generally, but does not create the websites for them. Its customers are able to craft their own websites to suit their needs. *** similarly offers professional website designers the ability to create websites for their own customers using their own label. It is clear that the use made of the software on *** website amounts to manipulation of the said software. Therefore, *** customers manipulate its software so that they have possession and control to constitute a rental within the meaning of the personal property rental classification.

For remote access software arrangements like the one offered by ***, the server location where the software and files are “physically” stored makes no difference for Arizona TPT purposes. It is the location where a user uses the software that is essential. As such, *** gross receipts derived from the rental of tangible personal property in the form of software are taxable when received from Arizona customers. The flat monthly fees charged to professional designers are also taxable for TPT purposes since those designers are also making use of the software.¹¹

The tax base for the personal property rental classification is the gross proceeds of sales or gross income derived from the business and includes all fees and charges associated with the rental of tangible personal property and is not limited to only those fees or charges identified as “rent.” A.A.C. R15-5-1502(D) specifically indicates that other fees are included as part of the personal property rental tax base even if such fees are separately stated. Thus, in addition to fees collected under Plans 2, 3 and 4, the following fees¹² collected by *** are also included in its tax base under the personal property rental classification:

- Processing fees under Plan 1
- Charges for third party applications
- Charges for digital stock photography

*** indicates that its income generated from domain registration fees is significant; but that it does not specifically identify what portion (in terms of percentage) of its fees arise from domain name registration. Domain name registration services income represents income from the sale of intellectual property rights, intangible property. The transaction privilege tax only applies to retail sales of tangible personal property. Generally, income earned from the sale of intangible property is not subject to transaction privilege tax. However, in this case, because of A.A.C. R15-5-1502(D) this income will only be excluded from *** tax

¹¹ The Department does not make a determination regarding the taxability of the professional designers’ business activities for TPT purposes.

¹² The Department does not make a determination whether these fees are derived from a separate line of business because Company A considers them inconsequential and incidental to its core business.

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base if the revenue from domain name registration can be considered as coming from a separate line of business.

Determining whether transaction privilege tax applies to the receipts of a business that conducts potentially taxable and nontaxable activities necessitates examining the totality of the activities. If activities are incidental in the sense that they are inseparable from the principal business and interwoven in the operation thereof to the extent that they are in effect an essential part of the major business, then the gross receipts from such activities are included in the tax base subject to transaction privilege tax under the primary business classification.

The Arizona Supreme Court specifically addressed the exclusion of services from a prime contractor's taxable receipts in *State Tax Commission v. Holmes & Narver, Inc.*, 113 Ariz. 165, 548 P.2d 1162 (1976). In *Holmes & Narver*, the State contended that design and engineering services were included in gross receipts of the taxpayer's construction business. The Arizona Supreme Court disagreed with the State Tax Commission, and in doing so articulated a three-part test.

The court held that: 1) because it could be readily ascertained what part of the receipts was for design and engineering and what part was for construction; 2) because the design and engineering receipts were not inconsequential compared to the total amount of the project; and 3) because the design and engineering services were not incidental to the contracting business, the design and engineering receipts were not part of the contracting business for tax purposes.

In this case, *** separately states and itemizes its invoices for its various plans and options. *** core services include Plans 1, 2, 3, and 4 and the income generated from those plans form a major part of its total revenues. With the exception of the revenue generated from domain name registration, income from *** other options generate inconsequential revenue and thus should be included in its tax base. The question then is whether revenues from *** domain registration services can be excluded from its tax base because it is derived from a separate line of business.

*** has indicated that it cannot readily ascertain what part of its receipts are from domain name registration; and it cannot quantify in terms of a percentage how much of its income is associated with domain name registration. It only says that those revenues are a consequential part of its total income; that they are significant. In the case of *City of Phoenix v. Arizona Rent-A-Car Systems, Inc.*, 182 Ariz. 75, 893 P.2d 75 (App. 1995), the court had to determine whether refueling charges were part of a car rental company's tax

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base and integral to car rental business or the nontaxable sales of gasoline. In looking at the refueling charges (which amounted to \$2 million) the court noted “the proper focus is not on the dollars, but on the percentage of business represented by those dollars.”¹³ In that case, the refueling charge represented 2% of the company’s total income and that was held to be inconsequential.¹⁴ Because *** is unable to determine what percentage of its gross income is attributable to domain name registration, the Department holds that the *Holmes & Narver* criteria for finding a separate line of business is not met and the revenues from domain name registration is also included in *** tax base.

This response is a taxpayer information ruling (TIR) and the determination herein is 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 taxpayer information 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.

If the Department is provided with required taxpayer identifying information and taxpayer representative authorization before the proposed publication date (for a published TIR) or date specified by the Department (for an unpublished TIR), the TIR will be binding on the Department with respect to the taxpayer that requested the ruling. In addition, the ruling will apply only to transactions that occur or tax liabilities that accrue from and after the date the taxpayer receives the ruling. The ruling may not be relied upon, cited, or introduced into evidence in any proceeding by a taxpayer other than the taxpayer who has received the taxpayer information ruling. If the required information is not provided by the specified date, the taxpayer information ruling is non-binding for the purpose of abating interest, penalty or tax.

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¹³ *City of Phoenix v. Arizona Rent-A-Car Sys., Inc.*, 182 Ariz. 75, 78, 893 P.2d 75, 78 (Ct. App. 1995)

¹⁴ In *Holmes & Narver*, the court noted that an amount representing 43% of the fixed fee represented the engineering services and that amount was consequential.