STATE OF ARIZONA

Department of Revenue
Office of the Director
(602) 716-6090

Janice K. Brewer
Governor

Gale Garriott
Director

CERTIFIED MAIL [redacted]

The Director's Review of the Decision of the Administrative Law Judge Regarding:	)	**O R D E R**
[redacted]	)	**Case No. [redacted]**
ID No. [redacted]	)	

On May 11, 2009, the Administrative Law Judge ("ALJ") issued a decision ("Decision") regarding the protest of [redacted] ("Taxpayer"). The Taxpayer appealed this Decision on June 10, 2009. As the appeal was timely, the Director ("Director") of the Department of Revenue ("Department") issued a notice of intent to review the Decision.

In accordance with the notice given the parties, the Director has reviewed the ALJ's Decision and now issues this order.

STATEMENT OF CASE

The Transaction Privilege and Use Tax Section in the Audit Division ("Division") of the Department audited Taxpayer for the period of June 1, 2002 through May 31, 2006 and disallowed deductions from transaction privilege tax under the retail classification that Taxpayer had claimed for receipts from software maintenance and support agreements with a newspaper publisher. As a result of that determination, the Division assessed additional transaction privilege tax and interest ("Assessment"). Taxpayer protested the Assessment, and the matter went to hearing. The ALJ upheld the Division's Assessment and denied Taxpayer's protest.

On appeal, Taxpayer argues that it is entitled to the claimed deductions. The Division argues that the Assessment was proper under the circumstances.

FINDINGS OF FACT

The Director adopts from the findings of fact in the Decision of the ALJ and makes additional findings of fact based on the record as set forth below:

1. Taxpayer creates and licenses software that is used in the newspaper publishing industry. The software consists of various components designed to assist in collecting and managing the content of a newspaper, such as text, graphics, photographs, and advertisements. The software allows writers, photographers, designers and others to submit materials to editors, and it enables editors to communicate with everyone involved and to combine the elements of a newspaper page through formatting, layout and pagination.

2. Once a newspaper page has been designed and created, the information is sent to a location where the printing takes place. Taxpayer's software does not run or control printing machines.

3. Taxpayer, having corporate locations in [redacted], sold and licensed its software to an Arizona newspaper publisher ("Publisher") for non-exclusive use in the newspaper publishing business. Taxpayer and Publisher signed their original contract ("Contract") in [redacted].

4. The Contract provides for a six-month warranty period for the software, system integration, and customization, and includes a mandatory "software maintenance agreement" taking effect at the expiration of the warranty period. Under the Contract, that "software maintenance" includes telephone application support, software support and troubleshooting via modem/ISDN, new software updates (fault corrections), and new software releases. The Contract states the amount of the quarterly fee for the "software maintenance" and provides that the fee is calculated as ten percent per year of the software license price.

5. In 1984, the Department issued a letter to Publisher in response to a request for guidance on the taxability of certain machinery and equipment purchases. The letter

notes that Publisher's list of items purchased included "computer systems and parts directly related to production process." The letter states that the items would be exempt from transaction privilege and use tax under exemptions for machinery and equipment used in manufacturing and other operations if used directly in the printing operation of Publisher's business.

6. The Division audited Taxpayer for the period of June 1, 2002 through May 31, 2006.

7. Taxpayer did not report Arizona transaction privilege tax during the audit period.

8. The Division determined that Taxpayer's receipts from Publisher for the "software maintenance" as provided under the Contract are taxable under the retail classification. In September 2006, the Division issued the Assessment of additional tax in the amount of [redacted] plus interest. No penalties were assessed.

CONCLUSIONS OF LAW

The Director adopts from the conclusions of law in the Decision of the ALJ and makes additional conclusions of law as follows:

1. A.R.S. § 42-5061 ("retail classification") imposes transaction privilege tax on the business of selling tangible personal property at retail. The tax base is the gross proceeds of sales or gross income derived from the business.

2. The Department's Transaction Privilege Tax Ruling ("TPR") 93-48 explains that the sale of "canned or pre-written computer software" is considered to be a sale of tangible personal property subject to tax under the retail classification. Canned software is software designed and manufactured for retail sale and not under the specifications or demands of any individual client. The provision of a canned computer program, whether or not characterized as a license agreement, is considered to be a taxable retail sale.

3. Taxpayer's software is "canned or pre-written computer software," and Taxpayer's income from its software sales and licensing to Publisher is gross proceeds of sales or gross income derived from the retail sales business.

4. The new software updates and releases that Taxpayer agreed to provide under the "software maintenance" portions of the Contract are also "canned or pre-written computer software," and Taxpayer's receipts from those software updates and releases are gross income from retail sales.

5. The tax imposed on the retail classification does not apply to proceeds from services rendered in addition to selling tangible personal property at retail. A.R.S. § 42-5061(A)(2).

6. A.R.S. § 42-5061(G) provides that a taxpayer must keep its books so as to show separately the gross proceeds of sales of tangible personal property and the gross income from sales of services to avoid being taxed on the total amount.

7. Taxpayer did not separately state its receipts from any services provided under the "software maintenance" portions of the Contract, and the total amount of Taxpayer's proceeds from "software maintenance" is subject to tax under A.R.S. § 42-5061 unless an exemption applies.

8. The tax imposed on the retail classification does not apply to sales of warranty or service contracts, but tangible personal property provided under the conditions of such contracts is subject to use tax under A.R.S. § 42-5156. A.R.S. § 42-5061(A)(3).

9. Software maintenance agreements that entitle a customer to receive canned updates, modifications or revisions to the software are not considered warranty or service contracts within the meaning of the exemption in A.R.S. § 42-5061(A)(3) for sales of warranty or service contracts, and are subject to tax as a sale of tangible personal property. See TPR 93-48.

10. A.R.S. § 42-5061(B)(1) (“machinery and equipment exemption”) provides a deduction from the retail tax base for gross proceeds of sales or gross income derived from sales of “[m]achinery, or equipment, used directly in manufacturing, processing, fabricating, job printing, refining or metallurgical operations.” The terms “manufacturing” and “job printing” as used in A.R.S. § 42-5061(B)(1) refer to and include “those operations commonly understood within their ordinary meaning.”

11. Arizona Administrative Code (“A.A.C.”) Rule 15-5-120(A) describes “manufacturing” as “the performance as a business of an integrated series of operations which place tangible personal property in a form, composition, or character different from that in which it was acquired and transforms it into a different product with a distinctive name, character, or use.”

12. A.R.S. § 42-5065 (“publication classification”) imposes transaction privilege tax on the business of publishing newspapers, magazines or other periodicals and publications if published in Arizona.

13. Pursuant to A.A.C. Rule 15-5-1303, a "publisher" is someone who “manufactures and distributes a publication” including newspapers, from a point within Arizona.

14. A.R.S. § 42-5066 (“job printing classification”) imposes transaction privilege tax on the business of job printing, engraving, embossing and copying.

15. TPR 94-2, concerning the business of job printing, explains that job printing activities include, but are not limited to, multigraphing, lithographing, photostating, multilithing, letterpress, offset or any other means of duplicating. TPR 94-2 further explains that the business of job printing includes pre-press composition activities such as typesetting, stripping, graphic artwork, color separation, and layout as well as post-press activities such as binding and mailing.

16. Exemptions from tax are to be narrowly construed. *Kitchell Contractors* v. *City of Phoenix***,** 151 Ariz. 139, 144, 726 P.2d 236 (App. 1986).

17. Job printing, but not publishing, is included in the list of business activities for which machinery or equipment must be directly used if it is to qualify for the exemption in A.R.S. § 42-5061(B)(1), and the exemption must be narrowly construed against an inclusion of the publishing business.

18. For purposes of determining whether an item is "used directly" in the operations listed in the machinery and equipment exemption, the "ultimate function" and "integrated rule" tests were developed by the Court of Appeals in *Duval Sierrita Corp. v. Arizona Department of Revenue*, 116 Ariz. 200, 568 P.2d 1098 (App. 1988) and explained and applied in *Arizona Department of Revenue v. Capitol Castings, Inc.*, 207 Ariz. 445, 88 P.3d 159 (2004).

19. Publisher's newspaper printing, even when seen as an integrated process, does not include the creation of the page content and the design and layout of the pages.

20. The doctrine of equitable estoppel may be asserted against state taxing authorities only if the affected taxpayer's reasonable reliance on the Department's action is established as one of several required elements. *Valencia Energy Co. v. Arizona Dep't of Revenue*, 191 Ariz. 565, 576-77, 959 P.2d 1256, 1267-68 (1998). Taxpayer could not reasonably rely in 2002 and later on a 1984 letter issued to a third party.

21. The ALJ properly denied Taxpayer's protest.

DISCUSSION

Taxpayer is requesting the review of the ALJ's Decision, which upheld the Assessment. Taxpayer argues that newspaper publishers are manufacturers and that its software qualifies for the machinery and equipment exemption under A.R.S. § 42-5061(B)(1). Taxpayer also argues that A.A.C. Rule 15-5-1303 defines publishers as manufacturers, that the Department advised Publisher in a 1984 letter that Publisher qualified for the machinery and equipment exemption, and that the Department's position in the Assessment cannot apply retroactively. Taxpayer further argues that the updates and the fault corrections provided under the "software maintenance agreement" are also exempt as

repair or replacement parts, and that telephonic support and remote troubleshooting are non-taxable services.

The Division argues that Publisher is not involved in "job printing" or "manufacturing" within the meaning of the machinery and equipment exemption and that Publisher, instead, is engaged in business and taxed under the publication classification of A.R.S. § 42-5065. The Division takes the position that Taxpayer's software does not control specific tasks, that it is not part of an automated assembly line, and that it is not used directly in manufacturing operations. The Division also argues that Taxpayer did not separately state any income from allegedly exempt services, and that any such services are therefore taxable.

The issue is whether Taxpayer's receipts from the "software maintenance" are taxable under the retail classification of A.R.S. § 42-5061. What Taxpayer refers to as the "software maintenance agreement" are provisions in Taxpayer's original Contract with Publisher,[1] according to which Taxpayer provides telephone application support, software support and troubleshooting via modem/ISDN, new software updates (fault corrections), and new software releases for a combined fee that is calculated as an annual percentage of the software license price.

Taxpayer's software is "canned" or pre-written computer software, and the sale of such software is considered to be a sale of tangible personal property that is subject to tax under the retail classification. See TPR 93-48. The software updates and new releases provided under the "software maintenance agreement" are also canned software. As the Department has explained in its TPR 93-48, software maintenance agreements that entitle a customer to receive canned updates, modifications or revisions to the software are not considered warranty or service contracts within the meaning of the exemption in A.R.S. § 42-5061(A)(3) for sales of warranty or service contracts, and are subject to tax as a sale of tangible personal property. Because Taxpayer charged a combined fee and did not separately state any services provided as "software maintenance," the total amount of

[1] Those provisions are paragraphs [redacted] of the Contract.

Taxpayer's proceeds from "software maintenance" is subject to tax under A.R.S. § 42-5061 unless an exemption applies. A.R.S. § 42-5061(G).

The next issue is whether Taxpayer's receipts from the "software maintenance" fall under the machinery and equipment exemption in A.R.S. § 42-5061(B)(1), as Taxpayer argues. A.R.S. § 42-5061(B)(1) provides an exemption for machinery and equipment "used directly in manufacturing, processing, fabricating, job printing, refining or metallurgical operations." Taxpayer argues that Publisher uses its software in "manufacturing" a newspaper, that newspaper publishers transform raw materials into a newspaper, and that they meet both the dictionary and the Department's regulatory definitions of a manufacturer.

A.A.C. Rule 15-5-120(A) describes "manufacturing" as "the performance as a business of an integrated series of operations which place tangible personal property in a form, composition, or character different from that in which it was acquired and transforms it into a different product with a distinctive name, character, or use." Although a newspaper may well be described as a different product than the paper and ink used in the printing process, and although A.A.C. Rule 15-5-1303 describes a "publisher" within the meaning of the publication classification of A.R.S. § 42-5065 as "someone who manufactures and distributes a publication, including newspapers, . . . ," the publishing of a newspaper is more than the transformation of paper into printed pages. Clearly, an emphasis in publishing lies in the acquisition, structuring and presentation of a publication's content rather than simply the transformation of paper. Newspaper publishing may not even include the printing on paper, especially given the availability of digital publications. Taxpayer's assertion, that newspaper publishers per se are manufacturers, does not take that into account.

Taxpayer cites *New Times, Inc. v. Ariz. Dep't of Revenue*, No. 973-92-U (Ariz. Bd. of Tax App., May 27, 1993), several decisions by courts in other states,[2] and Arizona Attorney General's Opinion 186-114 (Nov. 7, 1986). In the *New Times* case, the Board of Tax

[2] *Alabama v. Advertiser Co.,* 59 So.2d 576, 580 (Ala. 1952), *Hearst Corp. v. Md. Dep't of Assessments and Taxation,* 308 A.2d 679, 689-90 (Md. 1973), *Concord Pub. House, Inc. v. Mo. Dep't of Revenue*, 916 S.W.2d 186, 190-91 (Mo. 1996).

Appeals concluded that newspaper publishing involved “manufacturing” within the meaning of the machinery and equipment exemption, and that a computer hardware and software system utilized in the publication of a newspaper was used directly in a manufacturing process and therefore exempt. The Division points out that under A.R.S. § 42-1004(C), the Department is not bound by any determination of any other state agency. The Division further asserts that the *New Times* case was incorrectly decided and that the decision is not consistent with Arizona law because it expands the exemption beyond its logical limits.

Although a Board of Tax Appeals decision is not binding precedent, it may be instructive and is worth examining. In the *New Times* case, the Board noted that courts in several other jurisdictions held that newspaper publishing was manufacturing, and the Board stated simply that there was no evidence that the Arizona Legislature intended to the contrary. However, statutes granting an exemption from tax must be narrowly construed against an exemption. *Meredith Corporation v. State Tax Commission*, 23 Ariz. App. 152, 531P.2d 197 (1975), *Kitchell Contractors* v. *City of Phoenix***,** 151 Ariz. 139, 144, 726 P.2d 236 (App. 1986). Basing the interpretation of an exemption as including an item in question on the absence of legislative intent to the contrary is not consistent with the mandate of narrow construction.

The primary rule of statutory construction is to find and give effect to legislative intent. *Mail Boxes, Etc., U.S.A. v. Industrial Comm’n*, 181 Ariz. 119, 121, 888 P.2d 777, 779 (1995). To determine legislative intent, a court will first review a statute's language. *Calmat of Arizona v. State ex rel. Miller*, 176 Ariz. 190, 193, 859 P.2d 1323, 1326 (1993). If the legislative intent is not clear from that language, it will consider other factors, such as the context of the provision, its subject matter, purpose, effects, and consequences. *Wyatt v. Wehmueller*, 167 Ariz. 281, 284, 806 P.2d 870, 873 (1991).

Here, the existence of a specific tax classification in A.R.S. § 42-5065 for “the business of publishing newspapers, magazines or other periodicals and publications” indicates that the Arizona Legislature was well aware of that type of business and could have included it in the list of business activities for which machinery or equipment must be directly used if it is

to qualify for the exemption in A.R.S. § 42-5061(B)(1). The Arizona Legislature chose not to do so. That choice cannot be ignored in interpreting the machinery and equipment exemption. Decisions from other jurisdictions, where exemptions for manufacturing equipment were applied to printing equipment used in the publishing industry, but where there is no mentioning of a separate and distinct tax classification comprised of the publishing business, are therefore not readily applicable here.

Arizona Attorney General's Opinion 186-114 (Nov. 7, 1986) focuses on the broadcasting industry, concluding that broadcasters are not engaged in the business of manufacturing or processing for purposes of the equipment exemption, and mentions the granting of that exemption to print media publishers only in passing. The opinion is of 1986, and thus older than the publication classification of A.R.S. § 42-5065, which was added by Laws 1988, Ch. 161, § 4, eff. July 1, 1989. The opinion, therefore, is not instructive of the law in this case.

Taxpayer argues that the newspaper publishing business and the job printing business both include certain production activities such as printing, that job printers also act as manufacturers, and that job printing is listed in A.R.S. § 42-5061(B)(1) only to ensure that all machinery and equipment used directly in job printing qualifies for the exemption. That theory of "overlapping" business activities, however, does not explain why the Arizona Legislature would include job printing but not publishing in the list of qualifying business activities. If both businesses include and overlap with manufacturing, and if the Arizona Legislature had intended to exempt the printing equipment of both types of business, then it could have listed both businesses, or neither of them, to reach the same result for both businesses. But because only job printing is named in the exemption, a distinction was made, and the exemption must be narrowly construed against an inclusion of the publishing business.

Moreover, Taxpayer's software, as described by Taxpayer, does not function as a part of the actual printing process. Taxpayer argues that its software replaces and automates

tasks that previously had to be performed using physical equipment, such as linotype machines, and that it is a "production tool."

However, based on Taxpayer's description and the evidence taken at the formal hearing[3], the various distinct components of the software system relate mainly to the editing, design and layout of the newspaper's content. Rather than running or controlling printing machines, the software is used by reporters, editors, newspaper designers, and layout personnel to "handle the content", "manage . . . all of the photos", include advertisements, and "create the look" or "the map of the page" prior to sending that information to [redacted] where the printing takes place.[4]

To determine whether an item is "used directly" in the operations listed in the machinery and equipment exemption, the Arizona Court of Appeals developed the "ultimate function" and "integrated rule" tests. *Duval Sierrita Corp. v. Arizona Dep't of Revenue*, 116 Ariz. 200, 568 P.2d 1098 (App. 1988), *Arizona Dep't of Revenue v. Capitol Castings, Inc.*, 207 Ariz. 445, 88 P.3d 159 (2004). The printing, even when seen as an integrated process, does not begin until automatic plate makers at the printing plant receive the completed page design.[5] Taxpayer's software performs functions in the design of the newspaper rather than in the printing. Therefore, even if the printing component of Publisher's business were considered a manufacturing activity, Taxpayer's software would not be used directly in that part of the business.

Taxpayer further argues that the Department should be estopped from applying its position retroactively to Taxpayer's case because of the definition of a "publisher' in A.A.C. Rule 15-5-1303, and because of a 1984 information letter to Publisher. Under *Valencia Energy Co. v. Arizona Dep't of Revenue*, 191 Ariz. 565, 576-77, 959 P.2d 1256, 1267-68 (1998), the doctrine of equitable estoppel may be asserted against state taxing authorities only if several required elements are established, one of them being the affected taxpayer's

[3] See Taxpayer's transcript of recorded proceedings before the ALJ, Appendix A to Taxpayer's reply memorandum, pages 19, 26 and 29.
[4] Transcript at 39.
[5] Transcript at 40, 42.

reasonable reliance on the Department's action. Taxpayer could not reasonably rely in 2002 and later on a 1984 letter issued to a third party. Additionally, the letter was issued long before the introduction of the publication classification of A.R.S. § 42-5065 in 1988, and thus before the Arizona Legislature specifically recognized publishing as a separate and distinct business but without including it in the list of qualifying business activities in the machinery and equipment exemption of A.R.S. § 42-5061(B)(1).

Furthermore, pursuant to A.A.C. Rule 15-5-1303, a "publisher" is someone who manufactures and distributes a publication, including newspapers, from a point within Arizona. The rule defines the term "publisher" for purposes of the publication classification of A.R.S. § 42-5065 and does not serve as an interpretation of the term "manufacturing" in the machinery and equipment exemption of the retail classification. In the 1984 information letter to Publisher, a tax analyst explained that computer systems and parts directly related to a production process would qualify for the machinery and equipment exemption of the retail classification if they were used directly in the printing operation of Publisher's business. Even under the standards as explained in that letter, Taxpayer's software would not qualify for the exemption because it is not used directly in Publisher's printing operation and because the letter never concluded that the computer systems and parts were directly related to a production process, but simply used that description given by Publisher as a basis for its analysis. Taxpayer's estoppel argument is therefore misplaced.

The ALJ correctly determined that Taxpayer's proceeds from the "software maintenance" provision to Publisher were not exempt under A.R.S. § 42-5061(B)(1). The ALJ properly denied Taxpayer's protest.

ORDER

The ALJ's Decision is affirmed. .

This decision is the final order of the Department of Revenue. Taxpayers may contest the final order of the Department in one of two manners. Taxpayers may file an appeal to the State Board of Tax Appeals, 100 North 15th Avenue, Suite 140, Phoenix, AZ 85007 or may

bring an action in Tax Court (125 West Washington, Phoenix, Arizona 85003) within sixty (60) days of the receipt of this order. For appeal forms and other information from the Board of Tax Appeals, call (602) 364-1102. For information from the Tax Court, call (602) 506-3763.

Dated this 22nd day of January 2010.

ARIZONA DEPARTMENT OF REVENUE

Gale Garriott
Director

Certified original of the foregoing
mailed to:

[redacted]

cc: Transaction Privilege and Use Tax Section
Office of Administrative Hearings
Transaction Privilege Tax Appeals