STATE OF ARIZONA

Department of Revenue
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The Director's Review of the Decision of the Administrative Law Judge Regarding:	)	**O R D E R**
[redacted]	)	**Case No. 200900059 - S**
ID No. [redacted]	)	

On January 25, 2010, the Administrative Law Judge ("ALJ") issued a decision ("Decision") regarding the protest of [redacted] ("Taxpayer"). The Taxpayer requested and was granted an extension of time to file an appeal and appealed the Decision on April 1, 2010. As the appeal was timely under the extension granted, 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 July 1, 2002 through March 31, 2006 and determined that Taxpayer was taxable under the retail classification for the audit period. The Division reclassified the use tax reported by Taxpayer to transaction privilege tax under the retail classification and assessed additional county taxes 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 its income from licensing computer software is not subject to Arizona transaction privilege or use taxes, that it did not have nexus with Arizona for transaction privilege tax purposes and was not required to report transaction privilege

tax rather than use tax and, alternatively, that all or part of the assessed interest should be abated. 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 licenses the use of software products, developed and owned by an affiliated software company, to computer manufacturers and other high-volume users.

2. Taxpayer is headquartered in [redacted], where it maintains an office and employees.

3. Taxpayer does not own or lease office space in Arizona and does not have any employees located in Arizona.

4. Taxpayer enters into license agreements with Arizona customers through phone order, mail order and online order.

5. Taxpayer utilizes independent contractors to solicit business in Arizona, including the affiliated software company. In addition to soliciting business on Taxpayer's behalf through their Arizona business locations, the independent contractors offer optional phone support services, and Taxpayer's customers can enter into separate agreements with the affiliated software company for consulting and technical support services.

6. The Division audited Taxpayer for the period of July 1, 2002 through March 31, 2006 ("Audit Period").

7. Taxpayer reported and paid Arizona use tax for the Audit Period on its proceeds from license agreements with Arizona customers.

8. The Division determined that Taxpayer should have paid transaction privilege tax rather than use tax and reclassified the $[redacted] use tax reported by Taxpayer to

transaction privilege tax under the retail classification. As a result of that determination, the Division assessed associated county taxes of $[redacted] plus interest. No penalty was assessed.

9. Taxpayer protested the Assessment and argued that it had only a minimal presence and not a substantial presence in Arizona.

10. An informal conference was held on July 18, 2007. The matter was not resolved there, and Taxpayer signed a Notice of Action Taken at Informal Conference on July 19, 2007, requesting a formal hearing.

11. The Division contacted Taxpayer in November 2008 in an effort to resolve the matter informally and consolidate it with a related matter. Taxpayer asked that the formal hearing not be set until February or March 2009, so that it could retain local counsel.

12. In April 2009, the Division forwarded the matter to the Arizona Office of Administrative Hearings. A formal hearing was first scheduled for May 29, 2009. The hearing was rescheduled at Taxpayer's request and was held on August 3, 2009.

13. At the formal hearing and in post-hearing memoranda, Taxpayer argued that software is not tangible personal property subject to Arizona transaction privilege tax and that all or part of the assessed interest should be abated for at least the 22 months period between Taxpayer's July 2007 request for a formal hearing and the initially scheduled hearing date in May 2009.

14. The ALJ determined that Taxpayer's receipts were not exempt from the retail transaction privilege tax and that Taxpayer's activities created nexus with Arizona and were properly transaction privilege taxable.

15. The ALJ declined to make any determination regarding the requested abatement of interest.

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. "Tangible personal property" for purposes of the Arizona transaction privilege tax means "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(16).

3. A "sale" includes "any transfer of title or possession, or both, exchange, barter, lease or rental, conditional or otherwise, in any manner or by any means whatever . . . of tangible personal property or other activities taxable under this chapter, for a consideration. . ." A.R.S. § 42-5001(13).

4. Arizona Administrative Code ("A.A.C.") Rule 15-5-154(B) provides that gross receipts derived from the sale of computer software programs are taxable, regardless of the method that a retail business uses to transfer the programs to its customers. The only exception to that rule is for charges imposed for the creation or modification of programs for specific uses of individual customers that qualify as service activities pursuant to A.A.C. Rule 15-5-154(C).

5. 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.

6. Taxpayer provides prewritten or "canned" software through license agreements.

7. The Arizona Court of Appeals' decision in *Honeywell Information Systems, Inc. v. Maricopa County*, 118 Ariz. 171, 575 P.2d 801 (App. 1977), which treated the bundling of classroom education, systems support engineering services and computer programs collectively as intangible property for property tax purposes, does not preclude the taxation of Taxpayer's software under the retail classification. *See Southwest Airlines Co. v. Arizona Department of Revenue*, 217 Ariz. 451, 175 P.3d 700 (App. 2008).

8. Although courts in other states have treated computer software as intangible property in early decisions of the 1970s, e.g. *Commerce Union Bank v. Tidwell*, 538 S.W.2d 405 (1976), *Bullock v. Statistical Tabulating Corp.*, 549 S.W.2d 166 (1977), *Janesville Data Center v. Wisconsin Department of Revenue*, 84 Wis.2d 341, 267 N.W.2d 656 (1978), more recent decisions since 1983 have concluded that software is tangible personal property and that sales of software are taxable under state transaction privilege or sales and use tax provisions. *See Comptroller of the Treasury v. Equitable Trust Co.*, 296 Md. 459, 464 A2d 248 (1983), *Chittenden Trust Co. v. King*, 143 Vt. 271, 465 A2d 1100 (1983), *South Central Bell Telephone Co. v. Barthelemy*, 643 S.2d 1240, 36 A.L.R.5th 689 (La. 1994), *Wal-Mart Stores, Inc. v. City of Mobile*, 696 So.2d 290 (Ala. 1996).

9. The software that Taxpayer licenses to its customers is tangible personal property.

10. Taxpayer's licensing of software constitutes taxable retail sales. A.R.S. §§ 42-5001(13), 42-5061.

11. For the transaction privilege tax to be imposed, a taxpayer must have "substantial nexus" with the taxing state, which requires a physical presence in the state. *See Quill Corp. v. North Dakota*, 504 U.S. 298, 309-317, 112 S.Ct. 1904, 1911-1916 (1992).

12. The crucial factor governing nexus is whether the activities performed in Arizona on behalf of a taxpayer are significantly associated with the taxpayer's ability to

establish and maintain a market in this state. *See Tyler Pipe Industries, Inc. v. Washington Dep't of Revenue,* 483 U.S. 232, 250, 107 S.Ct. 2810, 2821 (1987).

13. A taxpayer that maintains no office or employees in the state, and that solicits business through independent contractors, may still have the requisite nexus with Arizona for imposition of the transaction privilege tax. *See Arizona Dep't of Revenue v. O'Connor, Cavanagh, Anderson, Killingsworth & Beshears, P.A.*, 192 Ariz. 200, 206-207, 963 P.2d 279, 285-286 (Ct.App. 1997).

14. The activities performed by independent contractors in Arizona on behalf of Taxpayer are significantly associated with Taxpayer's ability to establish and maintain a market in Arizona.

15. The former A.A.C. Rules 15-5-2306 through 15-5-2308 did not prevent the Department from assessing transaction privilege tax against a taxpayer that does not maintain a place of business within Arizona. S*ee Arizona Dep't of Revenue v. Care Computer Systems, Inc.*, 197 Ariz. 414, 418-419, 4 P.3d 469, 473-474 (Ct.App. 2000).

16. The assessment of transaction privilege tax against Taxpayer does not constitute a new interpretation of the law under A.R.S. § 42-2078.

17. Taxpayer had substantial nexus with Arizona and is liable for the tax assessed.

18. An abatement of interest under A.R.S. § 42-2065 requires an unreasonable error or delay by an officer or employee of the Department without any significant aspect of that error or delay being attributable to Taxpayer.

19. Significant portions of the time that passed between Taxpayer's request for a hearing and the first and second scheduled hearing dates are attributable to Taxpayer's requests not to schedule prior to February 2009 and for continuance of the first scheduled hearing date.

20. No interest can be abated. A.R.S. § 42-2065(B).

21. The ALJ properly denied Taxpayer's protest.

DISCUSSION

Taxpayer is requesting a review of the ALJ's Decision, which upheld the Assessment. Taxpayer argues that computer software is not tangible personal property, that income from the licensing of canned software is not subject to Arizona transaction privilege or use taxes and should not be taxed under the retail classification, and that this is an issue concerning the scope of a tax statute. Taxpayer also argues that it was not required to report transaction privilege tax instead of use tax because it did not maintain a place of business in Arizona, and because A.R.S. § 42-2078 prohibits the Department from applying new interpretations of the law retroactively. Finally, Taxpayer argues that, even if additional tax is due, all or part of the interest should be abated pursuant to A.R.S. § 42-2065.

The Division argues that computer software is tangible personal property and that the provision of a canned computer program, whether or not characterized as a license agreement, is a taxable retail sale. The Division also argues that Taxpayer had the degree of nexus necessary for the Department to assess transaction privilege tax. Furthermore, the Division argues that there was no unreasonable delay that would justify an abatement of interest.

The issues are whether Taxpayer's receipts from the licensing of software to Arizona customers are taxable under the retail classification of A.R.S. § 42-5061 and whether any of the assessed interest should be abated.

Tangible Personal Property

The retail classification is comprised of the business of selling tangible personal property at retail. A.R.S. § 42-5061(A). A.R.S. § 42-5001(16) defines "tangible personal property" to mean "personal property which may be seen, weighed, measured, felt or touched or is in any other manner perceptible to the senses."

Taxpayer argues that computer software is intangible property and is not tangible personal property within the meaning of A.R.S. § 42-5061(A). Taxpayer bases its argument on *Honeywell Information Systems, Inc. v. Maricopa County*, 118 Ariz. 171, 575 P.2d 801 (App. 1977) and also relies on decisions by courts in other states and countries.[1] Taxpayer advocates the application of an "essence of the transaction" test and argues that its customers enter into license agreements because they want to use the software, and that any tangible personal property that accompanies the software is inconsequential.

The Division argues that the decision in *Honeywell* does not preclude the taxation of software under the retail classification and cites *Southwest Airlines Co. v. Arizona Department of Revenue*, 217 Ariz. 451, 175 P.3d 700 (App. 2008). The Division points to A.A.C. Rule 15-5-154(B), TPR 93-48, and to other states' cases[2] decided after *Honeywell* for the position that the sale of pre-written or "canned" computer software is taxable as a retail sale of tangible personal property.

Taxpayer and the Division both describe the software that Taxpayer licenses to its customers as "canned" software products. It is therefore undisputed that the software at issue here is prewritten or "canned" software. With regard to computer software, A.A.C. Rule 15-5-154 provides:

> B. Except as provided in subsection (C), gross receipts derived from the sale of computer software programs are taxable, regardless of the method that a retail business uses to transfer the programs to its customers.
>
> C. Gross receipts derived from charges imposed for the following business activities originate from nontaxable service activities and are therefore not taxable:
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> 1. The original creation of an electronic data processing program for the specific use of an individual customer, or

[1] Taxpayer cites *First National Bank of Springfield v. Department of Revenue*, 85 Ill.2d 84, 421 N.E.2d 175 (1981), *First National Bank of Fort Worth v. Bullock*, 584 S.W.2d 548 (Tex. Civ. App. Austin 1979), *Janesville Data Center*, *Bullock*, *Commerce Union Bank* and *Continental Commercial Systems Corp. v. British Columbia*, ([1982] 5007 ETC, 1982 CanLII 458 (BC C.A.)).

[2] The Division cites *South Central Bell Telephone*, *Andrew Jergens Co. v. Wilkins*, 848 N.E.2d 499, 109 Ohio St.3d 396 (2006), and *Wal-Mart Stores*.

> 2. The modification of a prewritten computer software program for the specific use of an individual customer, if the charge for the modification is shown separately on the sales invoice and records.

The rule thus distinguishes software programs created or modified for the specific use of an individual customer from sales of other programs. In TPR 93-48, the Department further explains:

> 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. It includes software that may have originally been designed for one specific customer but which becomes available for sale to others. The design of a generally marketable software program which will be used by no one particular customer is not considered to be a service.

Pursuant to A.A.C. Rule 15-5-154 and as explained in TPR 93-48, sales of prewritten or "canned" computer software are therefore taxable under the retail classification of A.R.S. § 42-5061, and examining decisions by Arizona and other states' courts concerning the taxation of software only serves to clarify the context of the rule.

The Arizona Court of Appeals' decision in *Honeywell*, on which Taxpayer relies, was rendered in 1977, prior to the promulgation of A.A.C. Rule 15-5-154. At issue in *Honeywell* was the valuation for property tax purposes of bundled computer systems that included electronic data processing equipment as well as computer application programs, systems support engineering services and classroom education. The court referred to the classroom education, systems support engineering services and computer programs collectively as "software." *See Honeywell*, 118 Ariz. at 172, 575 P.2d at 802. With that understanding of "software," the court treated the bundled "computer software" as intangible property that was to be excluded in determining the value of tangible computer equipment. *Honeywell,* 118 Ariz. at 173, 575 P.2d at 803.

As the Court of Appeals observed more than 30 years later in 2008, in a case involving the valuation of avionics software, no Arizona court since *Honeywell* had addressed whether software may be taxed. *See Southwest Airlines*, 217 Ariz. at 456, 175 P.3d at 705. Regarding other states' cases, the court in *Southwest Airlines* noted:

> Although the older cases generally seemed to hold that software programs were intangibles not subject to tax, . . . more recent authorities conclude that software is tangible and subject to tax . . . .

Id. The court then stated that it was not required to determine whether it agreed with *Honeywell's* characterization of "software" as intangible property because the court in *Honeywell* had used the term "software" for bundled computer consulting services and did not focus on software programs, and because the taxation of the software in *Southwest Airlines* did not depend on the software being tangible property. *See Southwest Airlines*, 217 Ariz. at 456, 457, 175 P.3d at 705, 706.

Referring to the focus of the *Honeywell* court on computer consulting services, the court in *Southwest Airlines* explained:

> For that reason, we are reluctant to read into the *Honeywell* decision a pronouncement that any and all software *programs* (as opposed to computer consulting services) are intangible . . ..

Id. Pointing out that its upholding of the property tax was limited to the variety of software at issue, the *Southwest Airlines* court stated:

> [W]e do not hold that all software, regardless of use, necessarily is subject to taxation. Nor do we decide today whether computer software as a general matter is tangible or intangible for tax purposes.

Southwest Airlines, 217 Ariz. at 457, 175 P.3d at 706. The court declined to reject *Honeywell*, but concluded that *Honeywell* did not preclude taxation of the software at issue in *Southwest Airlines.* 217 Ariz. at 455, 175 P.3d at 704.

Although the decision in *Southwest Airlines* does not provide a clear precedent for the treatment of the software at issue here as either tangible or intangible property, it shows that Taxpayer cannot successfully rely on *Honeywell* for the position that the software programs should be considered intangible. Also, the *Southwest Airlines* court's notion that courts in other states more recently treated software as tangible and subject to tax, indicates that the court recognized a trend to classify computer software as tangible personal property.

The characterization of computer software as tangible or intangible property and its taxation under state transaction privilege or sales and use tax provisions have been the subject of court decisions since the 1970s.[3] In 1976, the Tennessee Supreme Court held that software consisting of standard design as well as specialized programs did not constitute a sale of tangible personal property and reasoned that the software was merely information transmitted by way of tangible media, such as punch cards, magnetic tapes or disks, and was separable from such media. *See Commerce Union Bank,* 538 S.W.2d at 408.

A number of state court opinions then adopted the view of software expressed in *Commerce Union Bank*. Among them were the cases that Taxpayer cites. In 1977, the Texas Supreme Court described coded or processed data as the object or the "essence of the transaction" for the software buyer. *See Bullock*, 549 S.W.2d at 168. The Wisconsin Supreme Court and the Texas Court of Civil Appeals followed that line of thought in 1978 and 1979, respectively. *See Janesville Data Center,* 84 Wis. 2d 341, 267 NW2d 656, *First National Bank of Fort Worth*, 584 S.W.2d 548. In 1981, the Supreme Court of Illinois held that the sale of computer software was nontaxable on the ground that software information and not the transfer of tapes was the substance of the transaction. *See First National Bank of Springfield*, 85 Ill.2d at 91, 421 N.E.2d at 179. These early decisions concerning the taxation of software sales, however, do not reflect later developments in the law.

[3] *See* Hellerstein, *State Taxation*, *Sales and Use Taxes* § 13.06[1] (3rd ed. at Thomson Reuters/RIA 2010).

In 1983, the Court of Appeals of Maryland rejected a "dominant purpose test" or a "conceptual severing of the insignificant blank tape from the valuable program copy superimposed thereon as magnetic impulses." *See Comptroller of the Treasury*, 296 Md. at 470, 464 A.2d at 254.

The court reasoned:

> A tape containing a copy of a canned program does not lose its tangible character, because its content is a reproduction of the product of intellectual effort, just as the phonorecord does not become intangible, because it is a reproduction of the product of artistic effort.

Id., 296 Md. at 484, 464 A.2d at 261.

Also in 1983, the Supreme Court of Vermont held that a bank's purchase of software was subject to use tax and rejected the argument that software programs are separable from the media on which they are contained. *See Chittenden Trust*, 143 Vt. at 274, 465 A.2d at 1102. The Louisiana Supreme Court extensively analyzed the case law concerning the taxation of computer software and concluded that software is tangible property "once the 'information' or 'knowledge' is transformed into physical existence and recorded in physical form." *See South Central Bell Telephone*, 643 So.2d at 1250. In 1996, the Alabama Supreme Court overruled its earlier decision in *State v. Central Computer Servs., Inc.*, 349 So.2d 1160 (Ala. 1977), and held that computer software was tangible personal property, the sale of which was subject to a gross receipts tax. *See Wal-Mart Stores*, 696 So.2d at 291. Whether based on case law, legislation or administrative rules, every state now treats the sale of canned software as a taxable sale of tangible personal property.[4] Taxpayer's argument ignores those developments in the law and the provisions of A.A.C. Rule 15-5-154.

Finally, it should be noted that the Arizona Board of Tax Appeals has addressed the characterization of software as tangible personal property in two decisions that are instructive. As here, the taxpayer in *IBM v. Arizona Dept. of Revenue*, No. 812-91-S

(B.T.A. January 1992) argued that all software was intangible and nontaxable pursuant to *Honeywell*. The Board rejected the taxpayer's argument, observed that *Honeywell* was decided during the early stages of the computer era and that it was "at variance with the growing body of law in this area," and explained:

> [T]he Department has clearly enunciated a policy that "canned" computer software, where the service aspect of the transaction is inconsequential, is tangible personal property, the sale of which is subject to tax.

IBM, Discussion, Part I.A. The Board concluded that the taxpayer had not met its burden of proving that the software at issue was customized and a nontaxable service. Similarly, the Board of Tax Appeals decided that all receipts from the licensing of software to financial institutions were subject to the transaction privilege tax as sales of tangible personal property. *Sendero v. Arizona Dept. of Revenue,* No. 800-90-S and No. 814-91-S (B.T.A. March 1992).

In sum, treating sales of prewritten or "canned" computer software as taxable retail sales pursuant to A.A.C. Rule 15-5-154, and as explained in TPR 93-48, is consistent not only with the interpretation of the *Honeywell* decision in *Southwest Airlines*, but also with other states' post-1983 case law. The Board of Tax Appeals' decisions illustrate that consistency.

Qualification of Licensing as Sales

Taxpayer argues that the licensing of software should not qualify as a sale because it does not give its customers an exclusive right to use the software. The Division argues that it should be irrelevant for tax purposes whether Taxpayer labels the transaction a license.

A.R.S. § 42-5001(13) defines a sale to include "any transfer of title or possession, or both … in any manner or by any means whatever . . . for a consideration." The broad definition of "sale" encompasses the gross receipts derived from sales of canned software as well as licensing agreements that provide for the continued use of the canned software program.

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[4] *See* Hellerstein, *State Taxation, Sales and Use Taxes* § 13.06[3].

See A.A.C. Rule 15-5-154. As explained in the Department's TPR 93-48, the provision of a canned computer program, whether or not characterized as a license agreement, is considered a taxable retail sale.

Nexus

Taxpayer argues that it reported use tax rather than transaction privilege tax because it did not maintain a place of business in Arizona, and that this was consistent with former A.A.C. Rules 15-5-2306 through 15-5-2308, which were in effect until August 6, 2005. Taxpayer also argues that pursuant to A.R.S. § 42-2078, the Department cannot apply new interpretations of the law retroactively in Taxpayer's situation.

The Division points to the Court of Appeals' decisions in *O'Connor* and *Care Computer Systems*, and argues that Taxpayer sought to establish a market in Arizona and had a physical presence in Arizona by using independent contractors to solicit sales.

According to Taxpayer's description of its business, it engages non-employee representatives, including the affiliated software company and various non-affiliated parties, to solicit sales on its behalf in Arizona. If a customer requires consulting or technical support, the customer will contract with the affiliated software company for such services.

The nexus with a taxing state of a taxpayer that maintains no office or employees in the state, and that solicits business through independent contractors, has been addressed by the U.S. Supreme Court as well as the Arizona Court of Appeals. Although the Supreme Court requires a physical presence as a prerequisite of "substantial nexus," *see Quill*, 504 U.S. at 309-317, 112 S.Ct. at 1911-1916, it found the requisite nexus for imposition of a gross receipts tax on a taxpayer who maintained no office, owned no property and had no employees residing in the taxing state, but who utilized independent contractors as sales representatives in the state. *See Tyler Pipe*, 483 U.S. at 249-251, 107 S.Ct. at 2821-2822. The Court stated:

> [T]he crucial factor governing nexus is whether the activities performed in this state on behalf of the taxpayer are significantly

> associated with the taxpayer's ability to establish and maintain a market in this state for the sales.

Tyler Pipe, 483 U.S. at 250, 107 S.Ct. at 2821.

Noting that the Supreme Court has never held that the required physical presence must include both resident employees and permanent facilities, and citing *Quill* and *Tyler Pipe*, the Arizona Court of Appeals found the required substantial nexus with Arizona where a taxpayer employed an independent manufacturer's representative in Phoenix, and where most of the delivery and installation work under a sales contract with an Arizona customer was physically accomplished by employees of the third-party independent contractor and a common carrier. *See O'Connor*, 192 Ariz. at 206-207, 963 P.2d at 285-286. As in *Tyler Pipe* and *O'Connor*, the activities performed by independent contractors in Arizona on behalf of Taxpayer are significantly associated with Taxpayer's ability to establish and maintain a market in Arizona.

Taxpayer's argument, that former A.A.C. Rules 15-5-2306 through 15-5-2308 prevented the Department from assessing transaction privilege tax against a taxpayer that does not maintain a place of business within Arizona, was rejected in *Care Computer Systems*, 197 Ariz. at 418-419, 4 P.3d at 473-474. The former rules provided in context:

> R15-5-2306. Distinction Between Sales Tax and Use Tax
>
> A. The Sales Tax is imposed on sales made by vendors located within Arizona, while the Use Tax is levied on purchases from out-of-state vendors.
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> B. Since the Sales Tax and Use Tax are complementary taxes, only one of the taxes can be applied to a given transaction.
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> R15-5-2307. When a Transaction is Subject to the Sales Tax
>
> Sales made by vendors maintaining a place of business within Arizona are subject to the Sales Tax. Sellers operating from a commercial location or point of distribution, soliciting from a public place of business, or buying and selling articles on their own account within the state are deemed to be in business in Arizona.
>
> For example, an office equipment dealer maintains a sales

> office in Arizona, solicits business from customers in Arizona, and orders the equipment from its home office out of state. Although the seller maintains no stock of inventory in Arizona and the products are shipped directly to the purchaser, he is nevertheless considered to be engaging in business within the state for purposes of this regulation. Such sales are taxable under the Sales Tax statutes.
>
> R15-5-2308. When a Transaction is Subject to the Use Tax
>
> Purchases made from vendors not maintaining a place of business in this state to Arizona customers are subject to the Use Tax. For example, purchases from an out-of-state vendor selling by mail order to Arizona residents are subject to the Use Tax.

These rules were repealed effective August 6, 2005. In *Care Computer Systems*, the taxpayer had argued that under those rules, the Department could not impose a transaction privilege tax on it because the taxpayer did not maintain a place of business within Arizona. *Id.*, 197 Ariz. at 418, 4 P.3d at 473. The Court of Appeals did not agree with that argument and stated:

> That the regulation in question specifies that vendors maintaining a place of business in Arizona are subject to the sales tax does not necessarily mean that other vendors are not subject to the sales tax.
>
> . . .
>
> [W]hile A.A.C. R15-5-2307 certainly says that a taxpayer who maintains a place of business in Arizona will be subject to the transaction privilege tax, it does not purport to exclude a taxpayer who does not maintain a place of business from the tax.

Id., 197 Ariz. at 419, 4 P.3d at 474. The assessment of transaction privilege tax against Taxpayer is therefore consistent with the former rules that were in place during part of the Audit Period, and it does not constitute a new interpretation of the law under A.R.S. § 42-2078.

Taxpayer had the requisite nexus with Arizona for imposition of the transaction privilege tax. Therefore, Taxpayer is liable for the tax assessed.

Interest Abatement

Taxpayer argues that interest should be abated due to unreasonable delay by the Department pursuant to A.R.S. § 42-2065 for at least 22 months, the period between Taxpayer's request for a formal hearing after its informal conference on July 18, 2007 and the initially scheduled hearing date of May 29, 2009.

The Division argues that no unreasonable delay exists to justify abatement of interest and submits a timeline of events and communications between the parties for the requested abatement period. The Division also argues that the Department's Transaction Privilege Tax Appeals Section ("Appeals Section") spent time conducting legal research for this case and was working on a part-time basis due to furloughs imposed as a result of the State's budget crisis. Furthermore, the Division argues that significant aspects of delay are attributable to Taxpayer.

A.R.S. § 42-2065 provides:

> A. The director, in the director's discretion, may abate all or part of any assessment if additional interest has accrued on:
>
> 1. A deficiency due to any unreasonable error or delay by an officer or employee of the department acting in the employee's official capacity.
>
> 2. Any payment of tax to the extent that any error or delay in the payment is attributable to an officer or employee of the department being unreasonably erroneous or dilatory.
>
> B. The director may consider an error or delay only if no significant aspect of the error or delay can be attributed to the taxpayer and after the department has contacted the taxpayer in writing with respect to the deficiency or payment.
>
> C. The director's decision is considered to be the department's final decision or order and is subject to appeal to the state board pursuant to section 42-1253.

To justify an abatement of interest under this provision, there would have to be an unreasonable error or delay by the Department without any significant aspect of that error or delay being attributable to Taxpayer. Taxpayer takes issue with the passage of 22 months between its request for hearing and the first scheduled hearing date. However, the passage of time, alone, does not establish that there was an unreasonable delay.

According to the timeline presented by the Division, this case proceeded through the administrative review process with the usual steps taken prior to the scheduling of a formal hearing before the ALJ. Taxpayer requested a formal hearing on July 19, 2007. The case was then evaluated by the Department's Protest Unit and transferred to the Appeals Section on December 28, 2007. There, the case was assigned to a tax counsel who conducted legal research. Taxpayer does not dispute that its representative, when contacted in November 2008, asked that a formal hearing not be set until February or March 2009, so that Taxpayer could retain local counsel. Although, at that time, approximately eleven months had passed since the case was transferred to the Appeals Section, Taxpayer's request contributed to the passage of time for which it is requesting abatement of interest and indicates that Taxpayer was not ready for a formal hearing by November 2008. Even after a formal hearing was first scheduled for May 29, 2009, Taxpayer requested a 90-day continuance because its local counsel had a scheduling conflict and also required time to familiarize himself with the case. Significant portions of the time that passed between Taxpayer's request for a hearing and the first and second scheduled hearing dates are attributable to Taxpayer. Therefore, pursuant to A.R.S. § 42-2065(B), no interest can be abated even if any delay might have been attributed to the Division.

ORDER

The ALJ's Decision is affirmed. Taxpayer's protest and request for interest abatement are denied. .

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 21st day of January 2011.

ARIZONA DEPARTMENT OF REVENUE

Gale Garriott
Director

Certified original of the foregoing
mailed to:

[redacted]

Copy of the foregoing mailed to:

[redacted]

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