

ARIZONA DEPARTMENT OF REVENUE

ARIZONA TRANSACTION PRIVILEGE TAX RULING

TPR 93-48

(Supersedes and Rescinds Arizona Tax Ruling No. 1-17-83)

This substantive policy statement is advisory only. A substantive policy statement does not include internal procedural documents that only affect the internal procedures of the agency and does not impose additional requirements or penalties on regulated parties or include confidential information or rules made in accordance with the Arizona administrative procedure act. If you believe that this substantive policy statement does impose additional requirements or penalties on regulated parties you may petition the agency under Arizona Revised Statutes § 41-1033 for a review of the statement.

(Note: On 10/9/2020, the statutory references were updated to use their current numbers. See footnotes for more details. In addition, the notes were added on pages 3 and 6. No substantive changes were made.)

ISSUE:

Taxation of computer hardware, software and related services.

APPLICABLE LAW:

Arizona Revised Statutes (A.R.S.) § 42-5061¹ levies the transaction privilege tax on the business of selling tangible personal property at retail.

A.R.S. § 42-5061(A)(1)² exempts from the transaction privilege tax professional or personal service occupations or businesses which involve sales or transfers of tangible personal property only as inconsequential elements.

¹ Originally this ruling referenced A.R.S. § 42-1310.01 which was renumbered as A.R.S. § 42-5061.

² Originally this ruling referenced A.R.S. § 42-1310.01(A)(1) which was renumbered as A.R.S. § 42-5061(A)(1).

A.R.S. § 42-5061(A)(2)³ exempts from the transaction privilege tax services rendered in addition to selling tangible personal property at retail.

A.R.S. § 42-5061(F)⁴ requires that a person's books be kept so as to show separately the gross proceeds of sales of tangible personal property and the gross income from sales of services. If the books are not kept in this manner, the tax is imposed on the total of the gross proceeds of sales of tangible personal property and gross income from services.

A.R.S. § 42-5071⁵ imposes the transaction privilege tax on the business of renting or leasing tangible personal property for a consideration.

A.R.S. § 42-5075⁶ levies the transaction privilege tax on the business of prime contracting.

Arizona Administrative Code (A.A.C.) rule R15-5-154 addresses computer hardware and software issues.

A.A.C. R15-5-104 and Arizona Transaction Privilege Tax Ruling TPR 90-2 discuss professional services with inconsequential transfer of tangible personal property.

DISCUSSION:

Computers, Computer Equipment, and Hardware

A.R.S. § 42-5061⁷ imposes the transaction privilege tax under the retail classification on the business of selling tangible personal property at retail. The sale of computers, computer equipment, hardware, and other related items is subject to tax as the sale of tangible personal property.

The lease or rental of these items is also subject to tax pursuant to

³ Originally this ruling referenced A.R.S. § 42-1310.01(A)(2) which was renumbered as A.R.S. § 42-5061(A)(2).

⁴ Originally this ruling referenced A.R.S. § 42-1310.01(F) which was renumbered as A.R.S. § 42-5061(F).

⁵ Originally this ruling referenced A.R.S. § 42-1310.11 which was renumbered as A.R.S. § 42-5071.

⁶ Originally this ruling referenced A.R.S. § 42-1310.16 which was renumbered as A.R.S. § 42-5075.

⁷ See footnote number 1.

A.R.S. § 42-5071⁸ which imposes the transaction privilege tax on the business of renting or leasing tangible personal property for a consideration.

If the installation of computer hardware involves altering, repairing, adding to or subtracting from real property, the charge for the specific installation activity is subject to tax under A.R.S. § 42-5075⁹ which levies the transaction privilege tax on the business of prime contracting. *[Note: The prime contracting classification has changed significantly since this ruling was issued and this paragraph should no longer be relied on. See A.R.S. § 42-5075 for information regarding what is taxed under the prime contracting classification.]*

Computer Software

Whether the sale of computer software is subject to transaction privilege tax is dependent upon the nature of the software.

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.

The provision of a canned computer program, whether or not characterized as a license agreement, is considered to be a taxable retail sale. Leases or rentals of this type of computer software are taxable under the personal property rental classification.

When canned software is installed, modifications may be made such as supplying requisite parameters and data for the program to perform on certain hardware. The modification of canned computer software at

⁸ See footnote number 5.

⁹ See footnote 6.

installation does not transform the canned software into custom software. Although the sale of the canned software is taxable, the charges for installation are exempt from tax provided the charges for the service are separately stated on the invoice and in the books and records.

In contrast to canned computer software, "custom computer software" is software designed exclusively to the specifications of one customer's unique application. The sale of such software is considered to be the sale of a professional service and not subject to tax. The service in this case is the dominant element and involves assessing needs, preparing specifications and developing and writing a program for a specific customer.

Maintenance/Warranty Agreements

A warranty or service contract may be sold in connection with the sale of computer hardware and software. A.R.S. § 42-5061(A)(3)¹⁰ provides an exemption from the transaction privilege tax for warranty or service contracts, the price of which is **separately** stated on the invoice and in the books and records. Tangible personal property provided under the terms of such a contract is subject to Arizona's use tax pursuant to A.R.S. § 42-5156¹¹ A warranty or service **contract** is to be contrasted with a warranty or service **provision**, which often accompanies the sale of tangible personal property. See Arizona Transaction Privilege Tax Ruling TPR 92-5 for information regarding warranty or service contracts.

Software maintenance agreements, which entitle the customer to receive canned updates, modifications or revisions, are not considered warranty or service contracts and therefore are subject to tax as a sale of tangible personal property.

Computer Services

A.R.S. § 42-5061(A)(2)¹² exempts from the transaction privilege tax

¹⁰ Originally this ruling referenced A.R.S. § 42-1310.01(A)(3) which was renumbered as A.R.S. § 42-5061(A)(3).

¹¹ Originally this ruling referenced A.R.S. § 42-1408.01 which was renumbered as A.R.S. § 42-5156.

¹² See footnote 3.

services rendered in addition to selling tangible personal property at retail. Computer services such as consulting, training, installation of software, and technical phone support are exempt from tax as professional services.

When income is received from both the sale of tangible personal property and exempt services, the charges must be separately stated on the invoice and clearly reflected in the books and records. If the charge for exempt service is not separately stated from the sale of tangible personal property, the gross income from the transaction is taxable.

RULING:

Gross receipts from the sale or rental of computers, computer equipment, hardware, pre-written software, and pre-written software updates are subject to the transaction privilege tax under the retail classification or the personal property rental classification.

The income received from the sale of custom software, warranty or service agreements and professional or technological services such as installation of software, training, consulting, and technical phone support is exempt from tax under the retail classification if separately stated on the invoice and in the books and records.

The income received from the installation of computer hardware which involves altering, repairing, adding to or subtracting from real property is subject to the transaction privilege tax under the prime contracting classification if such installation charges are separately stated on the invoice and in the books and records. *[Note: The prime contracting classification has changed significantly since this ruling was issued and this paragraph should no longer be relied on. See A.R.S. § 42-5075 for information regarding what is taxed under the prime contracting classification.]*

Harold Scott, Director

Date Signed January 3, 1994

Explanatory Notice

The purpose of a tax ruling is to provide interpretive guidance to the general public and to department personnel. A tax ruling is intended to encompass issues of law which are not adequately covered in statute, case law or administrative rules. A tax ruling is a position statement which provides interpretation, details or supplementary information concerning the application of the law. **Relevant statute, case law, or administrative rules, as well as a subsequent ruling, may modify or negate any or all of the provisions of any tax ruling.** See GTP 92-1 for more detailed information regarding documents issued by the Department of Revenue.