

PRIVATE TAXPAYER RULING LR02-022

November 27, 2002

This private taxpayer ruling is in response to your letter dated February 14, 2002, as updated on April 18, 2002. You have requested a ruling on behalf of your client, . . . ("Taxpayer"), regarding the Arizona Transaction Privilege Tax ("TPT") implications associated with Taxpayer's providing personal television services to customers located in the state of Arizona.

This private taxpayer ruling is limited to the TPT taxability of subscription fee income derived from personal television services Taxpayer proposes to provide presently to Arizona customers. The Department has a policy of not issuing private taxpayer rulings with respect to hypothetical scenarios, because relevant facts may be omitted. To prevent the misapplication of the Department's response, this ruling does not contemplate the taxability of future services Taxpayer hopes to offer Arizona customers.

Additionally, this ruling will address only state TPT liability. Regardless of whether a transaction is subject to TPT, local taxes imposed by municipalities in Arizona often apply. Cities and towns in Arizona impose privilege taxes that are similar to those of the state. The Model City Tax Code determines the imposition and administration of city taxes. Since municipal taxes are imposed under criteria distinct from state law criteria, this private taxpayer ruling does not address the city taxability of Taxpayer's services.

Statement of Facts:

The following is a restatement of the facts presented in your letter dated February 14, 2002.

In addition to providing direct-to-home satellite television services, Taxpayer is in the business of selling subscriptions to its personal television services. Subscribers may pay for Taxpayer's personal television services by a one-time upfront payment or by annual or monthly fees. These personal television services complement the personal video recorder ("PVR") the subscriber must have already purchased in a separate retail transaction (usually from a third party vendor). To enhance the capabilities of a subscriber's PVR unit, Taxpayer provides electronic program guides, specialized electronic television viewing guides, Taxpayer-produced programming, and software updates.

Taxpayer delivers its programming and viewing guides directly to the subscriber's PVR hard drive via a nightly electronic feed (through telephone line, satellite transmission, or other electronic transfer). The electronic program guide contains an approximately two-week schedule of television programs. The subscriber may use the program guide to identify and schedule future recordings and to indicate his or her viewing preferences, which help Taxpayer

make recommendations to the subscriber. The specialized electronic television viewing guide offers graphically-enhanced, interactive schedules, organized by topic or network. From time to time, Taxpayer also provides preview specials and other self-produced television programs. Like the guides, this content arrives in the subscriber's PVR hard drive electronically. In its periodic electronic feeds, Taxpayer occasionally includes updates to the PVR's software operating system. Electronic transmission of all the above-described personal television services originates at Taxpayer's operation facility outside of Arizona.

Issues:

1. What is the TPT treatment of Taxpayer's sale of the personal television services described above to customers located in Arizona?
2. When Taxpayer offers the above-described personal television services as a single component within a larger suite of services, some of which may be taxable, and bills for the entire transaction in a one-line-item invoice, how will the aggregate billing approach affect the TPT taxability of the personal television services?

Your Position:

It is your position that Taxpayer's personal television services do not fall under any specifically recognized TPT classification. You have concluded that Taxpayer provides a non-taxable service to its Arizona customers and accordingly, the personal television services, as described above, are not subject to TPT.

Applicable Law:

Arizona Revised Statutes ("A.R.S.") § 42-5064(A) defines the TPT telecommunications classification as "the business of providing intrastate telecommunications services." § 42-5064 (B) draws the tax base for this classification from "the gross proceeds of sales or gross income derived from the business, including the gross income derived from tolls, subscriptions and services on behalf of subscribers"

A.R.S. § 42-5064(A)(1) excludes "[s]ales of intrastate telecommunications services by a cable television system . . . or by a microwave television transmission system that transmits television programming to multiple subscribers and that is operated pursuant to 47 Code of Federal Regulations parts 21 and 74."

A.R.S. § 42-5061(A) defines the TPT retail classification as "the business of selling tangible personal property at retail" and states that "[t]he tax base for the retail classification is the gross proceeds of sales or gross income derived from the business."

Arizona Transaction Privilege Tax Ruling ("TPR") 93-48 states that "gross receipts from the sale . . . of computers, computer equipment, hardware, prewritten software, and pre-written software updates" are subject to TPT under the retail classification.

Pursuant to Arizona Administrative Code ("A.A.C.") R15-5-154(B), nontaxable service activity income includes "[i]ncome from the multiple use of data processing equipment where no single customer has exclusive use of the equipment for a fixed period of time, or where the customer does not exclusively control all manual operations necessary to operate the equipment"

In cases where a taxpayer receives income from both taxable activities and exempt information services, A.A.C. R15-5-154(E) states that "the charges for each shall be separately stated on billings and invoices or otherwise clearly reflected in the books and records of the taxpayer. If not so separately stated, the gross income from such transactions is taxable."

Discussion:

Arizona's transaction privilege tax is a tax on the privilege of conducting business in the state of Arizona. The seller may pass the burden of the tax on to the purchaser; the seller, however, is ultimately liable to Arizona for the tax.

The transaction privilege tax is imposed under 17 separate business classifications. A.R.S. § 42-5023 states, "[I]t shall be presumed that all gross proceeds of sales and gross income derived by a person from business activity classified under a taxable business classification comprise the tax base for the business until the contrary is established." The corollary to this presumption that gross proceeds from any activity included in a taxable classification contribute to the tax base is the presumption that proceeds from non-included activities do not contribute to the tax base. The scope of TPT must be definite and cannot be extended to include subject matter not covered under an activity listed in the statute. Dennis Development Co., Inc. v. Department of Revenue, 595 P.2d 1010, 1013-14 (Ariz. App. 1979). Therefore, if an activity does not fall under one of the 17 taxable business classifications, its associated gross proceeds will not be subject to TPT.

Taxable business classifications that are relevant to Taxpayer's personal television services include the telecommunications classification and the retail classification.

Telecommunications Classification

A.R.S. § 42-5064 governs the application of TPT to the business of providing intrastate

telecommunications services. Intrastate telecommunication services constitute "transmitting signs, signals, writing, images, sounds, messages, data or other information of any nature by wire, radio waves, light waves or other electromagnetic means if the information transmitted originates and terminates in [Arizona]." A.R.S. § 42-5064(C)(3).

Under the facts provided, Taxpayer offers direct-to-home satellite television services as well as the above-described personal television services. When supplying both services, Taxpayer charges a fee for its satellite services separate from its fee for personal television services. Taxpayer's satellite programming services are exempt from TPT under A.R.S. § 42-5064(A) (1), which excludes from the telecommunications classification any "[s]ales of intrastate telecommunications services by a cable television system . . . or by a microwave television transmission system that transmits television programming to multiple subscribers" Taxpayer's separately billed personal television services are not integral to its transmission services and are separately stated. Therefore, as long as proceeds from Taxpayer's personal television services are not inconsequential, they are not properly included under the telecommunications classification unless the personal television services themselves constitute telecommunications.

Viewing the personal television services aspect of Taxpayer's business in isolation from its satellite television services, Taxpayer is not selling telecommunications services. Taxpayer's personal television services use separately provided (by Taxpayer or other vendor) telecommunications service; the personal television services themselves do not supply the communication. Therefore, with respect to its personal television services, Taxpayer is not engaged in the business of providing intrastate telecommunications services, and revenues from the personal television services are not subject to TPT under the telecommunications classification.

Furthermore, the TPT telecommunications classification applies to sales of *intrastate* telecommunications services. *Interstate* telecommunications services are not taxable under the telecommunications classification. In Cable Plus Company, L.P. v. Arizona Department of Revenue, 4 P.3d 1050 (Ariz. App. 2000), the Arizona Court of Appeals clarified A.R.S. § 42-5064's definition of intrastate. The origination point of the information content, not the source of the electromagnetic means of transmission, determines the applicability of the intrastate telecommunications tax. When the actual production of the transmitted information takes place outside of Arizona, the activity of providing this information is not intrastate telecommunication services as defined under A.R.S. § 42-5064(C)(3). Id. at 1052. The data that constitute Taxpayer's personal television services originate from outside of Arizona. Therefore, not only are its personal television services not properly telecommunications services, but such personal television services are also not intrastate services. The telecommunications classification does not apply.

Retail Classification

A.R.S. § 42-5061 applies TPT to gross income from the business of selling tangible personal property for any purpose other than for resale. The taxable tangible personal property status of Taxpayer's personal television services depends upon whether they constitute (a) computer software, which is periodically downloaded into the subscriber's PVR, or (b) information services.

TPR 93-48 distinguishes between "canned or pre-written" computer software and customized software. The former includes standardized software marketable to the general consumer and the latter covers only specially-designed software manufactured for unique customer application. The TPT retail classification taxes canned software and related updates as tangible personal property but excludes customized software as nontaxable professional services. According to TPR 93-48, services involve "assessing needs, preparing specifications and developing and writing a program for a specific customer." Taxpayer has not developed its personal television services to individual customer specifications. If Taxpayer's product is software, it is prewritten software, the sale of which is taxable as the sale of tangible personal property.

Alternatively, Taxpayer's personal television services may constitute only information services, not software. A.A.C. R15-5-154 addresses the taxability of revenues received from the "multiple use of data processing equipment where no single customer has exclusive use of the equipment for a fixed period of time. . . ." The programming and viewing guides and Taxpayer-produced programming elements of personal television services are comparable to providing nonexclusive access to an interactive database. Because multiple customers can simultaneously access the electronic guides and content and no single customer has exclusive control of the information Taxpayer provides, sales of the guides and content fit into the rule's ambit. Under A.A.C. R15-5-154(B), that portion of the personal television services that comprises sales of access to the shared data is nontaxable service income.

Under the facts provided, any prewritten software involved in Taxpayer's personal television services business already exists inside the PVR. The separate PVR sale transaction (not at issue here) covers the taxable sale of such imbedded software. TPR 93-48, however, rules that gross receipts from the sale of "pre-written software updates are subject to the transaction privilege tax under the retail classification." The operating system updates portion of the personal television services creates a sale of taxable tangible personal property within the Taxpayer's otherwise nontaxable information services.

Nontaxable Services and Retail Sales – Aggregate Billing

Your description of Taxpayer's personal television services subsumes the periodic software updates into the programming guide, viewing guide, and content services. The software updates Taxpayer provides are subject to TPT under the retail classification, and integrating the updates with personal television services will not change that result.

Combining software updates with the other personal television services may cause taxability of the entire subscription sale. A.A.C. R15-5-154(E) states, "When income is received from both the sale of tangible personal property and exempt services, the charges for each shall be separately stated on billings and invoices or otherwise clearly reflected in the books and records of the taxpayer. If not so separately stated, the gross income from such transactions is taxable." Accordingly, to avoid taxability of the entire personal television services transaction, Taxpayer must separately bill or clearly distinguish in its books and records the sale of software updates from the sale of the programming/viewing guides and self-produced content.

The facts you provided indicate Taxpayer offers and bills its personal television services in conjunction with other, taxable transactions. While you do not indicate what taxable services other than software updates Taxpayer integrates into its subscriptions, combining these services will also affect the taxability of the entire subscription.

TPR 93-48 explains that sales of "computers, computer equipment, hardware," and "pre-written software" are taxable under the retail classification. Accordingly, selling a PVR constitutes a taxable sale of tangible personal property and the seller (whether the Taxpayer or a third party vendor) is liable for TPT on the proceeds. Regardless of whether the Taxpayer offers taxable items within a larger package of its non-taxable television services, the sale of those items is taxable. Like the problems raised by failing to separate taxable software updates from the non-taxable services, incorporating a PVR sale or other taxable transaction within a suite of services that includes the nontaxable personal television services may cause taxability of those personal television services. To avoid taxability of combined transactions as a whole, Taxpayer must separately bill the taxable and nontaxable charges on its invoices or distinguish them in its books and records.

Conclusion and Ruling:

On the basis of the information provided, Taxpayer's sale of subscriptions for personal television services does not fall under the TPT telecommunications classification. Furthermore, only the software update element of Taxpayer's personal television services creates a sale under the TPT retail classification.

The following ruling is given based on the facts presented in your request.

The Department rules that the electronic program guides, the specialized electronic television viewing guides, and the programming content specifically created by Taxpayer constitute

information services; income derived from their sale is exempt from Arizona Transaction Privilege Tax. Updates to operating system software, however, constitute tangible personal property, and related income is subject to Arizona Transaction Privilege Tax under the retail classification.

The Department further rules that combining exempt information services with software updates or other taxable products and failing to bill them separately and to distinguish them in Taxpayer's books and records will make the entire subscription sale subject to Arizona Transaction Privilege Tax under the retail classification.

The conclusions in this private taxpayer ruling do not extend beyond the facts presented in your letters dated February 14, 2002 and April 18, 2002.

This response is a private taxpayer ruling and the determinations herein are 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 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.

The determinations in this private taxpayer ruling are applicable only to the taxpayer requesting the ruling and may not be relied upon, cited nor introduced into evidence in any proceeding by a taxpayer other than the taxpayer who has received the private taxpayer ruling.