STATE OF ARIZONA
Department of Revenue

Janet Napolitano
Governor

J. Elliott Hibbs
Director

PRIVATE TAXPAYER RULING LR04-007

August 31, 2004

The Department issues this private taxpayer ruling in response to your letter of June 9, 2004, in which you request a ruling on behalf of your client . . . ("Taxpayer") . . . on the applicability of Arizona transaction privilege tax under several unique factual circumstances and on specific business activities engaged in by Taxpayer. You also submitted a supplement to your June 9 request on June 30, responding to the Department's request for further clarification on a number of substantive areas.

Statement of Facts:

The following facts are excerpted from your June 9 letter:

> [Taxpayer] develops and owns a suite of computer software products that support the administration of healthcare plans and healthcare payer organizations, and provides various business and technology consulting and development services to health care organizations. . . .
>
> . . . .
>
> IV. Statement of Facts
>
> [Taxpayer] maintains its headquarters in Phoenix, Arizona. [Taxpayer] provides information solutions for healthcare organizations throughout the country including software, information technology consulting and outsourcing. . . .
>
> [Taxpayer] has two broad categories of business activities – various consulting and development services, and software licensing. [Taxpayer] develops and owns a suite of computer software products that support the administration of healthcare plans and healthcare payer organizations. [Taxpayer] also provides a host of professional services in the nature of various business and technology consulting and development services to healthcare organizations.
>
> A. Licensing, Maintenance and Support of Non-Custom or "Canned" Software
>
> [Taxpayer] develops healthcare software that is licensed to healthcare organizations both in Arizona and outside of Arizona. Although [Taxpayer] does custom design and programming work as discussed below, generally the software it licenses starts with a previously written set of code. The Department refers to this type of software as "canned" or "prewritten" software as it is software that is not written or developed for a particular user. This type of software is licensed to the customer, and the fees are paid to [Taxpayer], under a form of Software License and Maintenance Agreement. This form of agreement includes specific references to the software license fee and to the separate fee charged for maintenance and support services for the software licensed. . . . [Taxpayer] will refer herein to the license,

maintenance and support services delineated in the Software License and Maintenance Agreement that relate to non-custom, prewritten or "canned" software as "License Fees."

. . . .

The prewritten software is generally licensed to customers for a monthly License Fee that includes the license rights to use the software and provides for maintenance and upgrades/patches. The License Fee is broken down into license and maintenance fees that are itemized separately from all other services, fees and expenses in the contracts with customers and on the monthly invoices sent to customers.

Under the Software License and Maintenance Agreement, [Taxpayer] has entered into a contractual relationship to license its software for use by a third party customer. This Software License and Maintenance Agreement provides for the licensee to pay consideration in the form of License Fees for the right of the use of the software while [Taxpayer] retains all ownership interests therein and for the right to receive maintenance and support for the licensed software. Furthermore, the licensee's permitted uses of the software are limited. Specifically, the licensee may not make the software available to third parties by duplication, renting, marketing, distributing or for processing third party data.

The software produced by [Taxpayer] is not sold to a customer, but is merely licensed. Additionally, the customers are not provided with any tangible medium such as disks or tapes. Rather, the software is usually downloaded by [Taxpayer] personnel via the Internet directly to a customer's computer system. Customer may make and retain copies for backup and archival purposes only and only during the license term.

A customer can choose to have the pre-written software installed on equipment located in their offices, either instate or out of state. These customers house and use all data, software and equipment at their operations location(s). In addition to contracting to use the pre-written software under the Software License and Maintenance Agreement, a customer enters into a separate Professional Services Agreement (discussed in detail . . . below) whereby [Taxpayer] will, for additional consideration and fees, provide the array of services listed below such as implementation and installation, application processing, customer development, hardware environment and consulting services.

Alternatively, a customer can use the pre-written software via the Internet and have it installed on hardware located on dedicated computer equipment located at an independent third party data center (not operated by [Taxpayer]) in the City of Phoenix. These data centers can be located in nearly any state or city, but the one utilized currently for [Taxpayer]'s customers is located in the City of Phoenix. Customers choosing this option are referred to as "hosted customers."

A hosted customer uses the software in its home location, generally an out-of-state location. The location of the software at the independent data center does not diminish or change the customer's complete access to or ability to use the software, reports, data, etc., and full operational capabilities with respect to all data input into its system through Internet connections and dedicated lines, and the option to have the software moved to its on-site location.

Like non-hosted clients, in addition to contracting to use the prewritten software under the Software License and Maintenance Agreement, a hosted customer enters into a separate Professional Services Agreement (discussed in detail . . . below) whereby [Taxpayer] will, for additional consideration and fees, provide the array of services listed below such as

implementation and installation, application processing, customer development, hardware environment and consulting services. In addition to License Fees for use of the software and maintenance, a Services (hosting) Fee is charged for use of the "hosting" service and facility.

License Fees, charged for licensing and maintenance of the prewritten software, are distinguished from all other services or fees that a customer might purchase or utilize. This segregation is consistent with [Taxpayer]'s contracts with and invoicing to customers, which separately note the fees for professional services, licensing charges, and expense reimbursements.

. . . .

B. Consulting, Programming, and Other Services

In addition to offering software licensing, [Taxpayer] also provides a wide variety of services to its customers, including: . . .

- business process consulting
- systems and network consulting
- custom programming for electronic data interchange and reports
- training and development
- online and written documentation preparation
- telephone support and issue management
- new software validation
- application and business process workshops
- new release orientation, installation and implementation
- other services described in an individual Work Order.

These services are offered under an agreement separate from the Software License and Maintenance Agreement called the Master Professional Services Agreement. . . . Herein these categories will be referred to as "Development and Consulting Services."

[Taxpayer] provides the types of services described as Development and Consulting Services generally on an hourly basis, with charges quoted in per hour increments. Customers are billed on a monthly basis for the number of Development and Consulting Services hours devoted to their projects and issues. The monthly invoices itemize separately the licensing fees, expense reimbursements, categories of Development and Consulting Services used, and any other items for which the customer is being billed. . . .

Customers purchase Development and Consulting Services generally on an hourly basis. Customers are given the option to pay for services as they are incurred or to purchase service hours in advance and pre-pay for the hours. Customers who choose to pre-pay for Development and Consulting Services are given a discount off of the standard hourly rates. The pre-paid hours can be used for any of [Taxpayer]'s Development and Consulting Services, including training, custom design and programming, implementation and assessment, and systems and network consulting. As pre-paid hours are utilized during a month, the customer's account is updated to reflect that prepaid hours were used. Any hours utilized over and above a pre-paid number of hours are charged at the then-current hourly rate for Development and Consulting Services.

Customers may use [Taxpayer]'s prewritten software, but purchase the Development and Consulting Services in whole or in part from other software development or consulting firms

> that are unrelated to [Taxpayer]. A customer may also use [Taxpayer]'s software and purchase all necessary Development and Consulting Services from [Taxpayer]. A customer is free to choose to take only a license for software from [Taxpayer] and not purchase any Development or Consulting Services from [Taxpayer]. The fee for licensing and maintenance of the software does not vary depending on whether or not a customer chooses to also purchase from [Taxpayer] Development and Consulting Services.
>
> . . . .
>
> VI. Analysis
>
> A. Summary of Facts
>
> . . . .
>
> [Taxpayer] has nonresident customers of two types. All out of state customers are nonresidents of Arizona and utilize the software outside this state, with the software use and access thereto occurring outside this state. [Taxpayer] has some hosted customers located out of state.

In your June 30 letter supplementing the June 9 ruling request, you provided further information on Taxpayer's abovementioned business activities:

> As noted previously, [Taxpayer] offers hosting as an additional service to its customers. All of [Taxpayer]'s software products and other professional services are available to every customer whether hosted by [Taxpayer] or self-hosted by the customer. A hosted customer uses the software licensed from [Taxpayer] in its home location, generally an out-of-state location. The software is loaded onto hardware and is serviced by an "independent data center." Currently the data center used by [Taxpayer]'s hosted customers is in Phoenix, but such a data center can be located in nearly any state or city. . . . The location of the software does not diminish or change the customer's complete access to or ability to use the software, reports, data, etc., and full operational capabilities with respect to all data input into its system through Internet connections and dedicated lines, and the option to have the software moved to its on-site location.
>
> . . . .
>
> . . . As noted previously, customers are generally invoiced on a monthly basis. Invoices itemize separately the [L]icense [F]ees, maintenance and support fees, expenses (e.g., travel expenses), professional services utilized, and any other items to be paid by the customer. [Taxpayer]'s books and records segregate and separately account for the stream of revenue from each activity, whether it is license revenue, maintenance and support revenue, expense reimbursements, or professional services income. The fees charged to the hosted clients are separate fees for hosting, services that are billed and accounted for separately from other fees and charges . . . .
>
> The hosted customers' revenue is broken out between the hosted license fees, the hosted maintenance fees and the actual hosting service. Hosting expenses from the data center flow through a separate general ledger account as a cost of revenue. Hosting fees are separate fees listed in the contracts, and in some instances the hosting activity is in a separate contract or work order from the license agreement. At this point in time, the contract with the independent data center is directly between [Taxpayer] and the independent

> data center, with the hosting fee back to the customer including the charge [Taxpayer] pays the independent data center and a charge to cover the hosting support.
>
> . . . .
>
> [Taxpayer] helps to support its customers, hosted and non-hosted, when database issues arise or other specific software issues arise. [Taxpayer]'s Database Administration Services, available as a professional service to hosted and non-hosted clients alike, include activities such as to create and configure the initial software database; provide the necessary information and tools to insure releases are compatible with the database and provide [Structured Query Language (SQL)] scripts or the other services required for updating the database; provide analysis of load balancing and recommendations for maximum performance; database optimization planning; act as liaison with Microsoft support if SQL anomalies are encountered; provide table reindexing, [DataBase Consistency Checker (DBCC)] execution and evaluation, and statistical updates; engage in server capacity maintenance; engage in maintenance of security and network access; and perform database server hardware configuration planning. In general, [Taxpayer] will, for a price, provide all services for a hosted or a non-hosted customer upon request.
>
> . . . .
>
> [The Department] asked whether the data files of hosted clients are treated the same as those housed on the customer's premises for non-hosted customers, specifically asking who owns the data files, who holds the files when the license agreement is terminated, and whether the files are housed separately for each client at the independent data center. The customer owns all of the data and data file[s]. The files are physically segregated by customer on individual server(s) at the data center to meet requirements of the Health Insurance Portability and Accountability Act of 1996. All data files are returned to the customer in the event of a contract termination.
>
> . . . .
>
> . . . Upgrades and patches to [Taxpayer] software are provided through the customer's maintenance and support fee. Customers, whether hosted or non-hosted, have the option to install the upgrade/patch themselves and in addition, they determine when a patch or upgrade is installed. If the upgrade is to a newer version of [Taxpayer] software that may require significant custom configuration, the customer could enter into a separate Professional Services work order, for a separate fee, to assist them in the upgrade. Maintenance and support of [Taxpayer]'s software products are essentially handled in the same manner for hosted and non-hosted customers.
>
> . . . .
>
> . . . No additional software is required for a hosted environment. ["Software System"] is not an additional software requirement for a hosted client, but is a custom application required for Medicaid plans that must report their claims experience to the state. Hosted and non-hosted clients may use the application.

The boilerplate "Software License and Maintenance Agreement" you attached to your June 9 request provided to following information:

1. Definitions

"Use" means, subject in all cases to the restrictions set forth in Schedule A [where customer-specific restrictions may be listed], the use, execution, display, loading, utilization, viewing, storage or display of the Software for Customer's internal purposes only, to administer healthcare benefits for Members, in accordance with the use for which the Software was designed.

2. License

. . . .

2.2 Delivery; Copying of Documentation. Promptly following the Effective Date or any later date specified in Schedule A, [Taxpayer] will deliver to Customer only via electronic delivery one (1) machine-readable electronic copy of the Software in Object Code form which includes: (i) a set of standard report templates; (ii) a method to facilitate electronic data import and export to and from the Software database, if applicable; (iii) the data table and structure and interface method to facilitate loading, editing and maintenance of reference data required to operate the Software; and (iv) the Documentation [assorted Software-related manuals and guides]. Subject to the requirements of Section 8 of this Agreement [providing for confidential information and ownership], Customer may reproduce the Documentation for its own internal use by printing the electronic files and the online help files.

. . . .

9. Term and Termination

. . . .

9.4 Effect of Termination. In the event this Agreement is terminated for any reason, Customer shall immediately pay all License Fees, all Maintenance and Support Fees and other amounts payable pursuant to this Agreement due to [Taxpayer] through the date of termination, shall immediately discontinue use of and shall return to [Taxpayer] all Software, Documentation and any Confidential Information provided by [Taxpayer], and all copies thereof, and shall within thirty (30) days of termination deliver a certificate of compliance with this provision signed by an executive officer of Customer. Within such thirty (30) day period, [Taxpayer] shall also return any Customer Confidential Information.

Your Issues:

In your June 9 request, you summarize the issues you wish the Department to address as follows:

1. Whether License Fees, covering the license, maintenance and support of "canned" software, are not subject to tax when the customer is not a resident of Arizona and is located out-of-state, the software is delivered to the customer at a location outside the State, and the software is licensed for use and used outside the State[.]

2. Whether License Fees, covering the license, maintenance and support of "canned" or prewritten software, are not subject to tax for "hosted customers" where the customer is not a resident of Arizona and is located out-of-state, and the software is housed on dedicated computer equipment in Arizona at an independent data center for use of the

out-of-state customer, and where the software is made available to the customer via Internet for use by the customer exclusively out-of-state at the customer's location[.]

3. Whether [Taxpayer]'s implementation, installation, assessment, hosting and other professional and consulting services, whether delivered inside or outside of the State of Arizona, are not subject to tax when separately stated on customer invoices and in [Taxpayer]'s books and records because they are professional or personal services not subject to tax or are excluded from the tax base[.]

Your Positions:

Your positions regarding the above-mentioned issues are as follows, again as presented in your June 9 request:

1. License Fees, covering the license, maintenance and support of "canned" or prewritten software, are not subject to tax when the customer is not a resident of Arizona and is located out-of-state, the software is delivered to the customer at a location outside the State, and the software is licensed for use and used outside the State.

2. License Fees, covering the license, maintenance and support of "canned" or prewritten software, are not subject to tax for "hosted" customers where the customer is not a resident of Arizona and is located out-of-state, and the software is housed on dedicated computer equipment in Arizona at an independent data center for use of the out-of-state customer, and where the software is made available to the customer via Internet for use by the customer exclusively out-of-state at the customer's location.

3. [Taxpayer]'s implementation, installation, assessment, hosting and other professional and consulting services, whether delivered inside or outside of the State of Arizona, are not subject to tax when separately stated on customer invoices and in [Taxpayer]'s books and records because they are professional or personal services not subject to tax or are excluded from the tax base.

Conclusion and Ruling:

Based on the facts presented, the Department concludes that the transactions undertaken with Taxpayer's Software License and Maintenance Agreements constitute leases or rentals of tangible personal property. Arizona Revised Statutes ("A.R.S.") § 42-5001(13) broadly defines "sale" as:

> 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, and includes:
>
> (a) Any transaction by which the possession of property is transferred but the seller retains the title as security for the payment of the price . . . .

Nevertheless, the tax base for the retail classification for Arizona transaction privilege tax is limited to the business of "selling" tangible personal property "at retail," which A.R.S. § 42-5061(U)(3) limits to sales "for any purpose other than for resale in the regular course of business in the form of tangible personal property, *but transfer of possession, lease and rental as used in the definition of sale mean only such transactions as are found on investigation to be in lieu of sales as defined without the words lease or rental*." Transfers of possession, leases, and rentals are instead subject to transaction privilege tax under the personal property rental classification found at A.R.S. § 42-5071.

Each Software License and Maintenance Agreement has the effect of providing a customer, for a consideration, with the defined right of use of the licensed software for a specified period, unaccompanied by a similar transfer of title over the software. The agreement allows Taxpayer to transfer the canned software and subsequent updates and patches directly (*i.e.*, to the customer's business location) or indirectly (*i.e.*, to an independent third-party data center that houses the software for the customer) to the customer. Either form of transfer, however, provides Taxpayer's customer with exclusive use of the software for the period specified in the Software License and Maintenance Agreement. Also significantly, when the agreement is terminated or concluded, the same Software License and Maintenance Agreement obligates Taxpayer's customer to "discontinue use of and . . . return to [Taxpayer] all Software, Documentation and any Confidential Information provided by [Taxpayer], and all copies thereof."

Under the facts as provided, Taxpayer's gross proceeds of sales or gross income derived from Software License and Maintenance Agreements—collectively called "License Fees" in the request—are leases or rentals subject to transaction privilege tax under the personal property rental classification.

While a specific exemption for professional or personal service occupations or businesses under the retail classification at A.R.S. § 42-5061(A)(1), no corollary exists for the personal property rental classification. Arizona Administrative Code ("A.A.C.") R15-5-1502(D) enunciates this principle by stating, "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."

Based on the above conclusions, the Department rules that:

1. Taxpayer's gross proceeds of sales or gross income derived from License Fees for a license to a customer that is an Arizona nonresident is not subject to transaction privilege tax when:

a. Taxpayer's licensed canned software is shipped, delivered, or otherwise transferred outside the state (*e.g.*, to a customer's out-of-state business location or an out-of-state data center) and intended, at the inception of the lease, for the nonresident customer's use exclusively outside of the state.

b. The nonresident customer removes and uses exclusively outside of the state Taxpayer's licensed canned software stored or otherwise used in Arizona at the inception of the lease.

2. Taxpayer's gross proceeds of sales or gross income derived from License Fees for a license sold to a customer that is a Arizona nonresident is not subject to transaction privilege tax when the licensed canned software and associated data files are stored in Arizona (e.g., on the dedicated computer equipment of an independent data center) if the nonresident customer uses the software (i.e., executing the program and generating data files with the program) exclusively outside of the state.

3. Taxpayer's gross income derived from the provision of the implementation, installation, assessment, hosting, maintenance and support fees, and other professional and consulting services specifically addressed in Taxpayer's private taxpayer ruling request are subject to Arizona transaction privilege tax when provided to an Arizona customer if they are directly related to Taxpayer's software lease or rental to the customer. If Taxpayer provides such services to Arizona customers and they are not related to any software lease or rental by Taxpayer, the services are exempt from transaction privilege tax as professional or personal services if the gross income derived from them is of a consequential nature to Taxpayer's business.

   If the abovementioned services are provided to Arizona nonresidents, the gross income derived from them is not subject to transaction privilege tax, regardless of whether they are related to leases of rentals of Taxpayer's software.

The conclusions in this private taxpayer ruling do not extend beyond the facts presented in your letters of June 9 and June 30, 2004.

This response is a private taxpayer ruling 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 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 only applicable 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.

Lrulings/04-007-D