PRIVATE TAXPAYER RULING LR04-010

November 15, 2004

The Department issues this private taxpayer ruling in response to your letter of June 17, 2004, in which you request a ruling on behalf of your company . . . ("Taxpayer") . . . on the applicability of Arizona transaction privilege tax to specific business activities engaged in by Taxpayer. The ruling is based on facts as provided in your original request as well as additional information submitted on September 1 and September 16, 2004 pursuant to the Department's request for further documents.

Statement of Facts:

Based on information submitted for this private taxpayer ruling and information filed with the Department for tax reporting purposes, Taxpayer's corporate headquarters are located in . . . New Hampshire but it has a business location in . . . Arizona through which it reports and remits Arizona transaction privilege tax. In the facts provided below, the customer . . . ("Customer") . . . is a company headquartered and doing business in Phoenix, Arizona.

The following facts are excerpted from your June 17 letter:

> . . . [Taxpayer]'s product offers a web-based training module platform that develops and markets a library of technological based education products.
>
> Per attached, [Taxpayer] entered into a lease and license agreement with [Customer] granting them use of our platform for a certain period of time and specific number of users. The product is accessed via the internet from any computer at any time with a designated domain name and password. . . .
>
> . . . [T]he product is located outside the state of Arizona on . . . [Taxpayer's] server. . . . [O]ur customer may download courses to their network and computers per Section 1.b of the attached Master Lease Agreement which states, "Customer may install, deploy and use the Courseware . . . and make copies of the Courseware on multiple local area networks and wide area networks, intranet servers and stand-alone computers at one or more Customer sites . . .". Although the original Master Lease Agreement supplied the Courseware via CD-ROM and later amended the agreement with Courseware supplied via the internet, Courseware is still defined as software and may be copied to a local network or computer from [Taxpayer]'s hosting site. (See Section 1. "Grant of License" of the original Master Lease and License Agreement attached)

Accompanying your request were several documents pertaining to the transactions, including a "Master Lease and License Agreement" ("Master Lease"), an "Amendment No. 1 to the Master Lease and License Agreement," ("First Amendment"), an "Amendment No. 2 to the Master Lease and License Agreement between [Taxpayer] and [Customer]" ("Second Amendment"), a third amendment changing the number of courses provided to

Customer, and a "Amendment 4 to the Master Lease and License Agreement" ("Fourth Amendment").

> License Period and Commitment. The Licenses granted hereunder commence and end as shown below. Customer's commitment for Courseware is also as set forth below:
>
> Term: 3 Years
> User Level: 500
> . . . .
> Payment Terms: Annual Prepaid, Net 30 Days
>
> . . . .
>
> 1. Grant of License. [Taxpayer] hereby grants to Customer a non-exclusive license to use the library of courses listed in Exhibit A, hereto and any substitute courses that [Taxpayer] herein provides to Customer pursuant to the terms of this Agreement. "Course" shall mean all training materials supplied hereunder, including hard copy [of] all machine-readable materials that comprise the training product and includes, but is not limited to, all software, data, disks, tapes, CD-ROM, documentation and packaging delivered to Customer.
>
> (a) The Courses may be used only for the training of Customer's employees.
>
> (b) Customer may install and use the Courseware solely within the United States and Canada and their possessions (or such greater territory as may be set forth in Exhibit A), and may make copies of the Courseware on multiple local area networks and wide area networks, intranet servers and stand-alone computers at one or more Customer sites.
>
> (c) Customer may provide access to the Course(s) up to the maximum number of users as specified on page one of this Agreement, however, that such use shall be by Customer employees, and labor personnel and consultants under contract with Customer, and only in connection with their employment or contracted duties with Customer.
>
> (d) Customer may make copies of the Course(s) for deployment purposes, provided that Customer reproduces all of [Taxpayer]'s proprietary notices and copyright notices which appear on the original version;
>
> (e) Customer shall not modify, translate, reverse engineer, decompile or dissemble any Course or any portion thereof;
>
> (f) Customer shall not transfer, loan, rent, lease, distribute, or grant any rights in any Course in any form or remove any proprietary notices, labels, or Marks on any Course. The license granted hereunder is non-assignable without consent in writing of [Taxpayer] which consent shall not be unreasonably withheld;
>
> . . . .
>
> (h) With respect to terms of greater than one year Customer may elect, at least one month prior to an anniversary date, to exchange one or more Courses to a maximum of the current library title size.

(i) Upon exchanging any title for another, or upon termination of this Agreement, Customer shall remove any and all copies of any titles from Customer's computers, and certify in writing to [Taxpayer] that the same has been done.

(j) Hosting Service. If so elected, in Exhibit A, the Customer may access the library of titles it has selected through the extranet services provided by [Taxpayer]. All terms of this Agreement shall apply regardless of the method of access.

. . . .

2. Term of Agreement; Breach and Termination. This agreement shall take effect upon the commencement date as set forth on the first page of this Agreement, and shall terminate as of the end date, unless terminated earlier pursuant to the terms of this Agreement. Either party may terminate this Agreement by written notice to the other party if either party fails to cure any default within thirty days after receiving written notice of such default from [Taxpayer]. Upon termination of this Agreement for any reason, Customer shall immediately erase or destroy all copies of any and all Courses, return all originals to [Taxpayer] and shall certify in writing to [Taxpayer] that it has done so.

. . . .

11. Renewal. [Taxpayer] agrees that Customer may elect to renew this Agreement for an additional one year term for the annual license fee equal to Thirty-Six Thousand Seven Hundred Twenty Dollars ($36,720.00) provided that Customer makes this election on or before [Date].

"Amendment No. 1 to the Master Lease and License Agreement" provides the following addendum provisions to the Master Lease and License Agreement:

3. Extranet Hosting Service. Commencing on the Effective Date of this Amendment and continuing through [Date], the Customer may access 50 of the library of titles it has selected through the extranet services provided by [Taxpayer] for an annual fee equal to $7,200.00. [Taxpayer] shall invoice Customer on the Effective Date of the Agreement in the amount of $5,400.00 and such fee shall be due and payable net thirty (30) days. "Extranet Hosting Services" is a method of delivery and access to the Course(s) whereby [Taxpayer] shall host the Course(s) on its servers and Customer shall obtain access to the Course(s) on the [Taxpayer] servers through the world wide web.

. . . .

4. [ ]PORT®. If so elected by the Customer, [Taxpayer] will provide Customer with its [ ]Port software, for the fees as set forth above, as part of its Extranet Hosting Services. If Customer discontinues the Extranet Hosting Services, [ ]Port will no longer be available as these services, if ordered, are provided by [Taxpayer] to the Customer simultaneously. [ ]Port is a proprietary web based e-learning application engineered to improve the processes for business learning.

"Amendment No. 2 to the Master Lease and License Agreement between [Taxpayer] and [Customer]" provides the following addendum provisions to the Master Lease and License Agreement:

2. Definitions:

2.1 "Course" shall mean the on-line computer-based training courses developed and owned by [Taxpayer] in the content areas relating to business and professional development, including all hard copy, machine-readable materials that comprise the Course, including but not limited to, all related software, data, disks, tapes, CD-ROM, documentation and packaging delivered to Customer.

2.2 "[ ]Simulation®" or "[ ]Sim®" shall mean the on-line computer-based training product developed and owned by [Taxpayer] based on a series of [Taxpayer] Courses which provides a learner [with] the opportunity to apply the lessons learned through an interactive simulation of a realistic business or professional workplace situation. The term [ ]Simulation and [ ]Sim shall include all hard copy, machine-readable materials that comprise the [ ]Simulation, including but not limited to, all related software, data, disks, tapes, CD-ROM, documentation and packaging delivered, including by electronic delivery, to Customer.

. . . .

4. [ ]Simulation Grant of License.

4.1 [Taxpayer] hereby grants to Customer a non-exclusive license to use the number of [ ]Simulations defined above, which shall be selected and ordered by the Customer on Exhibit A, and any substitute [ ]Simulation provided to Customer pursuant to the terms of this Agreement and Amendment No. 1.

4.2 The [ ]Sims may be used only for the training of Customer's employees.

4.3 Customer may install, deploy and use the [ ]Sims solely within the United States and Canada and their possessions and may make copies of the [ ]Sims on multiple local area networks and wide area networks, intranet servers and stand-alone computers at one or more Customer sites.

4.4 Customer may provide access to the [ ]Sims up to the maximum number of users as specified in Section 3 of this Amendment No. 1 [*sic*, 2] under User Level, however, that such use shall be by Customer employees only in connection with their employment with Customer.

4.5 Customer may make copies of the [ ]Sims for deployment purposes, provided that Customer reproduces all of [Taxpayer]'s proprietary notices and copyright notices which appear on the original version.

4.6 Customer shall not modify, translate, reverse engineer, decompile or dissemble any [ ]Sims or any portion thereof.

4.7 Customer shall not transfer, loan, rent, lease, distribute, or grant any rights in any [ ]Sims in any form or remove any proprietary notices, labels, or trademarks or servicemarks on any [ ]Sims. The license granted hereunder is non-assignable without the consent in writing of [Taxpayer] which consent shall not be unreasonably withheld.

4.8 All materials provided hereunder by [Taxpayer] to Customer are subject to copyright and contain confidential trade secret information belonging to [Taxpayer]. Customer agrees not to disclose any [ ]Sims or portion thereof to any third party or any person who is not an employee of Customer.

4.9 [Taxpayer] agrees that at the end of each annual term of this Agreement, Customer may elect to exchange one or more [ ]Sims up to the total maximum of No. of [ ]Sims licensed provided that Customer orders such exchange at least thirty (30) days prior to annual anniversary date.

4.10 Upon exchanging any [ ]Sim for another, or upon termination of this Agreement, Customer shall remove any and all copies of any [ ]Sims from Customer's computers, and certify in writing to [Taxpayer] that the same has been done.

4.11 Customer acknowledges that each [ ]Simulation is based [on] one or more or a series of commercially available Courses and the [ ]Simulation may contain references and on-line links to one or more Courses for which the [ ]Simulation is based. Therefore it is recommended, but not required, that Customer license from [Taxpayer] the Courses based on which the [ ]Simulation has been developed since selecting a link to a Course that is not licensed by Customer will create an error message and an interruption in the [ ]Sim operation.

"Amendment 4 to the Master Lease and License Agreement" provides the following addendum provisions to the Master Lease and License Agreement:

1. Definitions. Capitalized terms used but not defined in this Amendment No. 4 shall have the same meaning as in the Agreement, Amendment No. 1, Amendment No. 2 and Amendment No. 3.

. . . .

1.3 "Authorized Audience" shall mean (i) the Customer employees located in the United States that are authorized to access and use the [Taxpayer] Product(s) (as set forth in Section 2 of this Amendment No. 4). Customer shall limit the use of the [Taxpayer] Product(s) to the number of Authorized Audience members for whom Customer has paid the required license fees.

. . . .

1.6 "Solution Areas" shall mean the Course and/or [ ]Simulation bundles selected in Section 2.2 of this Amendment No. 4 and comprised of the Course(s) and/or [ ]Simulation(s) listed on Exhibit A-2 attached hereto, respectively, including any updates that [Taxpayer] supplies to Customer pursuant to the terms of this Amendment No. 4.

1.7 "[ ]Port®" means [Taxpayer]'s proprietary e-learning software application for launching, tracking and reporting usage of [Taxpayer] Course(s) and/or [ ]Simulation(s) delivered to Customer pursuant to the Agreement, together with any updates and modifications of such software program provided hereunder pursuant to the license granted herein.

. . . .

2 The parties agree that the License Period and Commitment set forth in Section 3 of Amendment No. 2 is hereby deleted and replaced with the following licenses for the License Term and Commitment set forth in Section 3 and Section 4 below. Therefore, [Taxpayer] hereby grants to Customer only the licenses and rights set forth below:

2.1 Multi-Modal Learning License. Multi-Modal Learning is a prepackaged offering of [Taxpayer] products and services as further defined in Section 1 above. Each Multi-Modal Learning license includes a license to the Solution Areas identified, subject tot the terms and conditions of Section 2.2., Platform Software, subject to Section 2.3 and Referenceware, subject to the terms and conditions of Section 2.5 and Mentoring, if applicable, subject to Section 2.4. Subject to the restrictions stated in this Agreement and the Exhibits attached hereto, [Taxpayer] grants to Customer, and Customer accepts, a nonexclusive, nontransferable license without the right to sublicense for the License Term to use, and to have the Authorized Audience (set forth below) access and use the Multi-Modal Learning license selected below in object code only for internal training purposes only. Under a Multi-Modal Learning license [Taxpayer] will provide Customer and the Authorized Audience with update(s) to some or all of the Multi-Modal Learning once per month during the License Term. For purposes of this paragraph and Section 1.5 of this Amendment No. 4, "updates" shall mean (i) any new Course(s) and/or [ ]Simulation(s) added to the Multi-Modal Learning license and/or (ii) all revisions and changes to, or modifications of, existing Course(s) and/or [ ]Simulation(s) included in a Multi-Modal Learning license, which [Taxpayer] may make available to its customers throughout the term of this Agreement.

. . . .

2.2 Solution Areas License. Subject to the restrictions stated in this Agreement and the Exhibits attached hereto, [Taxpayer] grants to Customer, and Customer accepts, a nonexclusive, non-transferable license without the right to sublicense for the License Term to use, and to have the Authorized Audience (set forth in Section 2.1 above) access and use the Solution Areas set forth in Section 1.4 in object code only for internal training purposes only. Under a Solution Areas license [Taxpayer] will provide Customer and the Authorized Audience with update(s) to some or all of the Solution Areas once per month during the License Term. . . .

2.3 Platform Software License. [Taxpayer] grants to Customer, and Customer accepts, a nonexclusive, non-transferable license for the License Term set forth in Section 3 of this Amendment No. 4 to use, and to have the Authorized Audience access and use, the Platform Software selected below for internal training purposes only. For purposes of this Agreement, "Platform Software" shall mean the technology infrastructure selected by Customer below and defined in Amendment No. 1 and Section 1 of this Amendment No. 4.

X	[ ]Port via Extranet Hosting Services
_____	Extranet Hosting Services without Platform Software
_____	Other:_____

Notwithstanding anything to the contrary set forth herein, if Customer selects any of the [ ]Port via Extranet Hosting Services, such license is only deployable through Extranet Hosting Services and the Platform Software/Extranet Hosting Commitment set forth in Section 4.1 of this Amendment No. 4 will include the cost of the Extranet Hosting Services.

Your Issue:

In your June 17 letter, you requested that the Department rule on whether gross proceeds of sales or gross income derived from the aforementioned products offered to Customer by Taxpayer for a consideration are subject to Arizona transaction privilege tax.

Your Position:

Based on the comments included in your June 17 letter, Taxpayer's position appears to be that gross proceeds of sales or gross income derived from its lease and license agreement with Customer for Taxpayer's software offerings offered for use or download over the Internet is subject to Arizona transaction privilege tax.

Conclusion and Ruling:

Based on the facts presented, the Department concludes that all the various software offerings described above that Taxpayers provide to Customer on a fee basis constitute "canned or prewritten software," designed and manufactured for lease or retail sale and not under the specifications or demands of any individual client. Canned or prewritten software includes software that may have originally been designed for one specific customer but becomes available for sale or lease to others. Sales of canned or prewritten software are considered sales of tangible personal property.

The Department also concludes that the transactions involving Taxpayer's canned software offerings, undertaken with Taxpayer's Master Lease and License Agreement, inclusive of subsequent amendments (collectively the "Agreement"), 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.

The 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 updates directly (*i.e.*, to the customer's business location) or indirectly (*i.e.*, to a hosting service that

houses the software for the customer) to the customer. Either form of transfer, however, provides Taxpayer's customer with use of the software and right to download and install the software for a specified period. Also significantly, when the Agreement is terminated or concluded, the same Agreement obligates Taxpayer's customer to "immediately erase or destroy all copies of any and all Courses, return all originals to [Taxpayer] and shall certify in writing to [Taxpayer] that it has done so."

Under the facts as provided, Taxpayers transactions involving Taxpayer's canned software offerings constitute leases or rentals of tangible personal property.

Pursuant to Arizona Administrative Code ("A.A.C.") R15-5-1503, gross receipts derived from the business of leasing or renting tangible personal property in Arizona for a consideration is sourced to the "business location." A.A.C. R15-5-1503(A)(1) defines "business location" as "the business address that appears on a lessor's privilege license, but if the lessor does not have a business address in Arizona, business location means the lessee's residential or primary business street address." When leased or rented property is "removed from the state and used exclusively outside the state," A.A.C. R15-5-1503(E) explains that gross receipts from the lease or rental are not subject to tax. Nevertheless, "[i]ntermittent use of tangible personal property outside of the state does not constitute removal of the property from the state for use exclusively outside of the state, and therefore does not change the business location of the property or liability for the tax."

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. 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 a software license leased to Customer or other Arizona customer is subject to transaction privilege tax under the personal property rental classification when the licensed canned software is stored outside of Arizona (e.g., through a hosting service) if the resident customer uses the software (i.e., by executing the software) in Arizona and not exclusively outside of the state.

2. Taxpayer's gross income derived from extranet hosting service provided to Customer or other Arizona customer is subject to Arizona transaction privilege tax if the service is directly related to Taxpayer's software lease or rental to the customer. If Taxpayer provides such

> service to Customer or other Arizona customer and it is not related to any software lease or rental by Taxpayer, the service is exempt from transaction privilege tax as a professional or personal service if the gross income derived from it is of a consequential nature to Taxpayer's business.

The conclusions in this private taxpayer ruling do not extend beyond the facts presented in your communications of June 17, September 1, and September 16, 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.