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Director

TAXPAYER INFORMATION RULING LR11-011

June 22, 2011

The Department issues this taxpayer information ruling in response to your letter of August 11, 2010, as supplemented by your letter of October 1, 2010, submitted on behalf of an unnamed client (the "Company"). You request a determination of the applicability of Arizona transaction privilege tax to software hosting activities conducted by Company in Arizona.

Statement of Facts:

The following facts are excerpted from your August 10 letter:

Company maintains its headquarters in . . . Arizona. Company hosts software for customers' use on secure servers located in [City]. The software is used by Company's customers to review large volumes of documents in preparation for litigation or regulatory matters. Company engages in other business activities[,] including the sale of DVDs, computer hard drives and other tangible personal property at retail. These sales are not the subject of this ruling request.

Company also provides litigation support services[;] a non-exhaustive list of Company's litigation support services are listed below. The taxability of these services is not at issue in this ruling request.

As was stated above, Company hosts software for its customer's use in a secure data center in Phoenix. The data center is equipped with a state of the art server room rack and cooling storage system and ensures that there will be a constant power supply by utilizing redundant generators and cooling towers. The facility is also wired to multiple city power grids, so their customers can be assured that the software is up and running at all times. Company's customers access the hosted software in the secure data center through a secure website to process and organize information in relation to regulatory matters or litigation.

Company's customers access the software remotely, through a web portal, exclusively on Company's servers and enter queries requesting documents that fit certain parameters established by the court or regulatory agency. The software then searches the data base of documents using various software packages. When the document is located it can be reviewed on line or printed to be entered into evidence in a court proceeding.

Company's customers are located both inside and out of Arizona. Company does not enter into software licenses with its customers but invoices them for hosting the software. These invoices include charges for hosting software based on usage or number of users; setup fees; [and] loading software on customer's computers[.] Copies of some representative invoices are provided for your review. More can be made available on request.

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Company's invoices separately state charges for the following items:

- Hosting of software per gigabyte per month
- Software license setup fee, one time, per user
- Loading software, one time charge
- Media, DVD, per unit
- Media HD, per unit

. . . While Company does not enter into formal software license agreements with its customers, by providing its customers with access to hosted software through its secure web portal, Company provides its customers, for a consideration, the right to use the software for a specified period, unaccompanied by a similar transfer of title to the software. Access to the software provides Company's customer with exclusive use of the software for the period that customer is using the software.

. . . Customers do not own the software license but pay on a subscription basis for them.

Your Issues:

Your ruling request raised two issues:

1. For transactions in which Company's customers are located in Arizona, are Company's gross proceeds of sales or gross income derived from hosting software on Company's servers subject to Arizona's transaction privilege tax?
2. For transactions in which Company's customers are located outside of Arizona, are Company's gross proceeds of sales or gross income derived from hosting software on Company's servers subject to Arizona's transaction privilege tax?

Your Positions:

Company's positions are as follows:

1. For transactions in which Company's customers are located in Arizona, Company's gross proceeds of sales or gross income derived from hosting software on Company's servers are subject to Arizona's transaction privilege tax.
2. For transactions in which Company's customers are located outside of Arizona, Company's gross proceeds of sales or gross income derived from hosting software on Company's servers are not subject to Arizona's transaction privilege tax.

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Discussion

Transaction Privilege Tax Imposed Under the Retail and Personal Property Rental Classifications

Products sold, leased, or rented as part of a business's taxable activities under the retail and personal property rental classifications are not limited to "physical goods," but rather, need only constitute "tangible personal property." Arizona's broad definition of tangible personal property is "personal property which may be seen, weighed, measured, felt or touched or is in any other manner perceptible to the senses."¹

The tax base for the retail transaction privilege tax is limited to the gross receipts derived from the business of selling tangible personal property "at retail." Retail sales are those "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.*"² Transfers of possession, leases, and rentals are instead generally subject to transaction privilege tax under the personal property rental classification

The personal property rental classification comprises "the business of leasing or renting tangible personal property for a consideration."³ While there are specific retail exemptions for professional or personal service occupations or businesses and for services rendered in addition to retail sales of tangible personal property, no corollaries exist under the personal property rental classification. Arizona Administrative Code ("A.A.C.") R15-5-1502(D) underscores this discrepancy between classifications in 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."

Hosted Software Applications

Under the traditional model, prewritten (canned) software has been sold at retail as "shrink-wrap" or "click-wrap" licenses, wherein a customer buys a license from a software producer or third-party retailer to use the software and installs it locally (e.g., from a CD-ROM or electronically-transferred package of files) on hardware belonging to or under the control of the customer; the software producer may subsequently provide support to the customer as

¹ A.R.S. 42-5001(16).

² A.R.S. § 42-5061(V)(3) (emphasis added).

³ A.R.S. § 42-5071(A).

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dictated by the software license agreement or a separate software support agreement.⁴ The Software-as-a-Service ("SaaS") model of software delivery to consumers is one in which a vendor hosts the application software (*i.e.*, stores the software application code on the vendor's servers or servers owned by a third party remote from the customers' premises), and customers access them over a network, typically the Internet using a web-based user interface.⁵ Customers do not own the software licenses but, rather, pay on a subscription basis (*e.g.*, on a per-application or usage basis) for using them.⁶

"Cloud" (*i.e.*, Internet-based) computing often involves, as a component, a "cloud application," one which exists partially or fully online. One example is the SaaS application described above, wherein software is not installed and run locally, reducing the need for localized software maintenance, deployment, management, and support.⁷ Because such offerings are typically subscription-based, they reduce or amortize the immediate front-end costs that are commonly associated with acquiring prewritten software licenses (*e.g.*, software and hardware costs, technical support, update fees, time to install and manage software).⁸ Another example is a Software plus Services ("S+S") model, a hybrid between traditional application development and SaaS wherein "rich client" applications are installed locally on a user's personal computer as an interface to externally hosted applications.⁹ Such offerings may be provided directly from a vendor or by a third-party intermediary called an aggregator, which bundles SaaS offerings from different vendors and offers them as a single package.¹⁰

The term "license," as used in the retail software sale context, has been described as "something of a technicality" because "legally, the customer is only purchasing the right to use a copy of the software, but for practical purposes, it's as though the customer 'owns'

⁴ See, *e.g.*, Frederick Chong & Gianpaolo Carraro, *Building Distributed Applications: Architecture Strategies for Catching the Long Tail*, MICROSOFT DEVELOPER NETWORK, Apr. 2006, <http://msdn.microsoft.com>; H. WARD CLASSEN, *SOFTWARE LICENSING FOR LICENSEES AND LICENSORS* 199-200 (3d ed. 2009).

⁵ R. KELLY RAINER JR. & EFRAIM TURBAN, *INTRODUCTION TO INFORMATION SYSTEMS* 358 (2009); Chong & Carraro, *supra* note 5; CLASSEN, *supra* note 5, at 143 (use of a third parties to manage and maintain software under "managed hosting" model). It has been observed that, from a terminology standpoint, "SaaS has superseded Application Service Provider (ASP) and "Utility Computing" as the industry's preferred name for purchasing software on a service basis." CLASSEN, *supra* note 5, at 143.

⁶ RAINER & TURBAN, *supra* note 6, at 358; Gianpaolo Carraro & Fred Chong, *Software as a Service (SaaS): An Enterprise Perspective*, MICROSOFT DEVELOPER NETWORK, Oct. 2006, <http://msdn.microsoft.com>; Chong & Carraro, *supra* note 12; CLASSEN, *supra* note 5, at 144. Note that, although the focus of the discussion is on the managed hosting model, wherein third parties are responsible for managing and maintaining customers' hardware and software, there are also "collocation" models where customers own all hardware and software and the third party merely provides a space, power, Internet connection, and basic monitoring ("power, pipe, and ping"). See CLASSEN, *supra* note 5, at 147.

⁷ Darry Chantry, *Mapping Applications to the Cloud*, MICROSOFT DEVELOPER NETWORK, Jan. 2009, <http://msdn.microsoft.com>; CLASSEN, *supra* note 5, at 143-44.

⁸ CLASSEN, *supra* note 5, at 28, 143-44.

⁹ Chantry, *supra* note 8.

¹⁰ See Carraro & Chong, *supra* note 7. This article also discusses the varying degrees to which programs can be partially or wholly reliant on SaaS-based architecture in usage (*e.g.*, when locally-run software depends in part on data produced by a SaaS application).

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the software and may use it as often and for as long as it wishes.”¹¹ Contrastingly, with an SaaS model, “instead of ‘owning’ important software outright, customers are told, they can pay for a subscription to software running on someone else’s servers, software that goes away if they stop subscribing.”¹²

For purposes of Arizona transaction privilege tax, the Department does not consider a license of tangible personal property the same as a taxable lease or rental. A software license, however, is dissimilar to arrangements that fall under the general “license” nomenclature used for leases and rentals of physical tangible personal property (e.g., property that can be touched or felt). As discussed, virtually all sales of prewritten software are sales of nonexclusive rights to use, regardless of whether they are sold on physical media or transmitted electronically or whether they have perpetual or limited terms.¹³ Because of the interplay of federal copyright laws and the differences in the meaning of the terms “sale” and “license” as used in the federal Copyright Act¹⁴ compared to common law applications used in Arizona tax law cases,¹⁵ a software license should not be confused with the common law concept of license. Tax treatment is based upon the rights that arise from a particular contractual arrangement; merely relying on how the arrangement is labeled can be misleading.

Separate Lines of Business

Although the Company does not explicitly address the subject in its ruling request, whether it is engaged in separate lines of business will affect how Company's business activities other than software hosting will be treated for transaction privilege tax purposes.

The Arizona Supreme Court has stated that “[i]f activities are incidental in the sense that they are inseparable from the principal business and interwoven in the operation thereof to the extent that they are in effect an essential part of the major business, they cannot be taxed as a separate business.”¹⁶

Determining whether a taxpayer has more than one line of business requires evaluating the relevant facts and circumstances pursuant to a three-part test established by the Supreme Court in *State Tax Commission v. Holmes & Narver, Inc.*¹⁷ The *Holmes & Narver* test provides that whether activities constitute a separate line of business depends on whether: (1) the portions of the separate activities can be readily ascertained without substantial difficulty, (2) the amounts attributable to the activities in relation to the taxpayer's total

¹¹ Chong & Carraro, *supra* note 5. Such software is commonly known as “shrink-wrapped” software in the industry.

¹² *Id.* at 23-24; Chong & Carraro, *supra* note 5.

¹³ For additional discussion on the rare occasions that exclusive software licenses are sold, see CLASSEN, *supra* note 5, at 27.

¹⁴ 17 U.S.C. § 101 et seq.

¹⁵ See, e.g., CLASSEN, *supra* note 6, at 19.

¹⁶ *Trico Electric Coop., Inc. v. State Tax Comm'n*, 79 Ariz. 293, 297, 288 P.2d 782, 784 (1955).

¹⁷ 113 Ariz. 165, 548 P.2d 1162 (1976) (en banc).

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taxable Arizona business are not inconsequential, and (3) the activities cannot be said to be incidental to the taxpayer's principal (taxable) business.¹⁸ If the relevant facts and circumstances fail to satisfy the three-prong test, all gross proceeds or gross income would be included as part of the taxpayer's principal business. If the facts and circumstances meet the three prongs, however, the activities would exist as a separate line or lines of business, and taxpayer's gross proceeds or gross income would be subject to tax under the appropriate tax classification for each line of business.

Ruling:

Based on the facts provided, the Department rules as follows:

1. Company's gross receipts derived from hosting software for Company's Arizona customers are subject to transaction privilege tax under the A.R.S. § 42-5071 personal property rental classification. As noted, Company provides its customers, for a consideration, the right to use the software for a specified period. Although this right is not accompanied by a formal license agreement for the software, the consideration constitutes gross receipts derived from software licensing activities that fall within the tax base for the personal property rental classification. No formal software licensing agreement is necessary.

To the extent that Company's is engaged in other business activities that, when viewed separately, would be taxable under another tax classification or constitute nontaxable activities, Company would need to establish that it engages in separate lines of business to remove gross receipts derived from such activities from the tax base for the personal property rental classification.

2. Company's gross receipts derive from hosting software for Company's customers located outside of Arizona—out-of-state lessees or persons using the software exclusively outside the state—are deductible under the personal property rental classification.

This private taxpayer ruling does not extend beyond the facts presented in your correspondence of August 11 and October 1, 2010.

This response is a taxpayer information ruling (TIR) 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 information ruling shall be null and void. Further, the determination is subject to future change depending on changes in

¹⁸ 113 Ariz. at 169, 548 P.2d at 1166.

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statutes, administrative rules, case law, or notification of a different Department position.

If the Department is provided with required taxpayer identifying information and taxpayer representative authorization before the proposed publication date (for a published TIR) or date specified by the Department (for an unpublished TIR), the TIR will be binding on the Department with respect to the taxpayer that requested the ruling. In addition, the ruling will apply only to transactions that occur or tax liabilities that accrue from and after the date the taxpayer receives the ruling. The ruling may not be relied upon, cited, or introduced into evidence in any proceeding by a taxpayer other than the taxpayer who has received the taxpayer information ruling. If the required information is not provided by the specified date, the taxpayer information ruling is non-binding for the purpose of abating interest, penalty or tax.

Lrulings/11-011-D