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Governor

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Director

## PRIVATE TAXPAYER RULING LR13-005

April 29, 2013

The Department issues this private taxpayer ruling in response to your letters of May 24, 2012 and August 7, 2012 (together, the "Request") requesting a ruling on behalf of . . . (the "Company"). Specifically, you request a ruling on the application of Arizona's transaction privilege tax ("TPT") to Company's employment application and selection business (the "Solution"). Pursuant to A.R.S. § 42-2101, the Department may issue private taxpayer rulings to taxpayers and potential taxpayers on request.

### ISSUE:

Whether the Company's gross receipts derived from its Solution business is subject to Arizona's transaction privilege tax?

### RULING:

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

Company is engaged in the business of renting tangible personal property in the form of prewritten software and is subject to transaction privilege tax under the personal property rental classification on its gross proceeds of sales or gross income derived from Arizona customers for its Solution.

### FACTS ASSERTED BY COMPANY:

The following are facts excerpted from your May 24, 2012 letter:

The Company provides customers with the Solution to improve the employee application gathering and selection process. To set up the Solution, customers provide the Company with, among other requirements, ad listings of their current employment opportunities and related job descriptions. The Company develops a customized internet web portal for each of its customers, which displays the employment opportunities for prospective employees. Customers have the . . . ability to add, delete, and modify job descriptions via the internet portal.

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The Company uses its software during the on-line application process to pose questions to applicants and to analyze the applicants' responses. Through the internet portal, customers can select which behavioral assessment questions they would like to pose to applicants. Once an applicant completes the assessment, the software utilizes an algorithm to analyze the applicant's responses and scores the applicant based upon said responses. The Solution then automatically produces on-line reports summarizing the result of its analysis. Once the application process is complete and a candidate is hired, the Solution performs new-hire on-boarding. The on-boarding function optimizes the productivity of the workforce by getting new employees working sooner. Specifically, the software automatically uploads information that was captured during the application process into various human resource, payroll, and tax forms.

The following fact is excerpted from your August 7, 2012 letter:

Upon termination of the contract, the customer's right to utilize the services is terminated and the connection with the Company's servers is terminated.

The following fact is excerpted from the "Services Agreement" which accompanied your May 24, 2012 letter:

All title and intellectual property rights in and to the underlying technology used in delivering Services hereunder, including, but not limited to the software, assessments and engineering knowhow and any updates, changes, alterations, or modifications to such intellectual property, will be and remain the property of Company or its third party licensors.

### **DISCUSSION & LEGAL ANALYSIS:**

#### *A. Software is tangible personal property.*

For the purposes of Arizona's transaction privilege and use taxes, tangible personal property is much more than physical goods that a person can hold, touch, or feel. As defined in A.R.S. § 42-5001(16), it is property "which may be seen, weighed, measured, felt or touched or is in any other manner perceptible to the senses." Consistent with this broad definition, there is longstanding precedent in case law for applying this broad definition of tangible personal property to subjects other than physical goods, such as electricity, electronic delivery of software, and music played from a jukebox.<sup>1</sup> The Arizona Supreme Court's decision in *State v. Jones* addressed the scope of the taxation of tangible personal

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<sup>1</sup> *State Tax Comm'n v. Marcus J. Lawrence Mem. Hosp.*, 108 Ariz. 198, 495 P.2d 129 (1972) (en banc); *State v. Jones*, 60 Ariz. 412, 137 P.2d 970 (1943).

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property.<sup>2</sup> In *State v. Jones*, the Arizona Supreme Court held when a person inserts a coin into a jukebox and listens to a phonograph record, he is purchasing tangible personal property.<sup>3</sup> The court held that the playing of the record is perceptible to the sense of hearing and, hence, constitutes tangible personal property under the statute.<sup>4</sup> The current definition is not substantively different from that considered by the *Jones* court in 1943. Even the Supreme Court of another state, in a use tax opinion, took note of the broad scope of Arizona's definition.<sup>5</sup>

According to the facts asserted by Company, Company's gross proceeds of sales or gross income derived from its employment application and selection business include receipts for software. Similar to the broad definition of tangible personal property applied to the music heard in *Jones*, Arizona's expansive definition of tangible personal property includes software because software is property that "may be seen, weighed, measured, felt or touched or is in any other manner perceptible to the senses." Therefore, Company's gross proceeds of sales or gross income include receipts from tangible personal property.

### *B. Company engages in the business of renting tangible personal property.*

A determination must be made as to whether the gross proceeds of sales derived from a transaction that involves computer software, including remote access software arrangements, are properly classified under the retail classification at A.R.S. § 42-5061, the personal property rental classification at A.R.S. § 42-5071, or are otherwise exempt from Arizona TPT. The tax base for the retail classification is limited to the gross receipts derived from the business of selling tangible personal property "at retail."<sup>6</sup> However, the gross receipts from the rental or leasing of tangible personal property are subject to TPT under A.R.S. § 42-5071, unless a specific exemption applies.<sup>7</sup>

A transaction in which a taxpayer derives receipts from offering computer based services with software and where the receipts are related to the software are generally subject to TPT. The rights that a taxpayer provides its customer under the precise terms of the contractual agreement helps determine the duration of the customer's access to the underlying software and whether a company cedes the requisite amount of use and possession so as to establish that it is renting tangible personal property. A business is subject to TPT under the retail classification if the taxpayer grants its customer the right to the underlying product for a perpetual duration. A business is subject to TPT under the personal property rental classification if the contractual agreement has the effect of providing a customer, for consideration, with the defined and exclusive right of use of the

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<sup>2</sup> *Jones*, 60 Ariz. at 415, 137 P.2d at 971.

<sup>3</sup> *Id.*, 60 Ariz. at 415, 137 P.2d at 971.

<sup>4</sup> *Id.*

<sup>5</sup> *Ramco, Inc. v. Director*, 248 N.W.2d 122, 124 (Iowa 1976).

<sup>6</sup> A.R.S. § 42-5061(A).

<sup>7</sup> A.R.S. § 42-5071; A.A.C. R15-5-154(B).

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software for a specified period, the termination or conclusion of which necessitates the customer's return of the software to the vendor. Constructive possession may be established through either the transfer of a software license or a level of use that establishes the user's possession of the software.

If the transaction is classified under the personal property rental classification, A.A.C. R15-5-1502(A) provides, "the gross income derived from the rental of tangible personal property is included in the tax base under the personal property rental classification unless a specific statutory exemption, exclusion, or deduction applies." While there is a specific exemption for professional or personal service occupations or businesses as well as one for services rendered in addition to retail sales of tangible personal property under the retail classification, no corollaries exist for the personal property rental classification. A.A.C. R15-5-1502(D) states, "[g]ross 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."

Company's customers use the software when customers add, delete, and modify job descriptions via the internet portal. In addition, customers can select which behavioral assessments questions they would like to pose to applicants. Also, the customers have the ability to search and sort information in the reports produced by Company. Company cedes the requisite amount of use and possession to its customers. Therefore, Company is engaging in the business of renting tangible personal property in the form of the computer software.

*C. Arizona TPT applies to all gross receipts collected from customers located in Arizona.*

Company has a physical presence in the State of Arizona and is taxable on all rentals of tangible personal property to Arizona customers. Rentals of tangible personal property to nonresidents of Arizona that is to be used exclusively outside of Arizona are not subject to tax. A.A.C. R-15-5-1503(D) states:

Gross receipts from leasing or renting tangible personal property are not taxable if the property is shipped or delivered outside of the state and intended, at the inception of the lease, for use exclusively outside of the state.

The burden of proof for establishing the applicability of subsection (D) is on the lessor.<sup>8</sup>

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<sup>8</sup> A.A.C. R15-5-1503(F).

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For remote access software arrangements, the server location where the software and files are “physically” stored makes no difference for Arizona TPT purposes. The location where the lessee uses the leased property on a non-temporary basis is what is determinative. A taxpayer’s gross receipts derived from software leased to in-state lessees who use the software at a location within Arizona are subject to tax. The gross receipts from leasing or renting tangible personal property are not taxable pursuant to A.A.C. R15-5-1503(D) if the property is shipped or delivered outside the state and intended, at the inception of the lease, for use exclusively outside of the state. Therefore, a taxpayer’s gross receipts derived from software leased to out-of-state lessees who use the software exclusively outside the state would be deductible.

**This response is a private taxpayer ruling and the determinations herein are based solely on the facts provided in the Request. Therefore, the conclusions in this private taxpayer ruling do not extend beyond the facts presented in your correspondence dated May 24, 2012 and August 7, 2012. 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 private 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. In addition, this private taxpayer ruling only applies to transactions that occur or tax liabilities that accrue from and after the date the taxpayer receives the ruling.**