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Governor

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Director

TAXPAYER INFORMATION RULING LR16-011

September 23, 2016

Thank you for your letter dated June 1, 2016, requesting a taxpayer information ruling (“TIR”) on behalf of your *** client (“***”). Specifically, you requested a ruling regarding the taxability for Arizona transaction privilege tax (“TPT”) purposes of ***’s income derived from certain transaction processing through the use of software. Pursuant to Arizona Revised Statutes (A.R.S.) § 42-2101, the Department may issue taxpayer information rulings to taxpayers and potential taxpayers on request.

ISSUE: Whether ***’s gross income derived from certain transaction processing through the use of computer software is taxable under the personal property rental classification for Arizona TPT purposes?

RULING: Both *** and its clients use the software; *** stores end user customer payment data on its servers after it is uploaded by the client, then it uses that information to request payment. In addition, *** updates information on its portal either manually or automatically so that its client may see the status of payments processed and other analytical information. Thus, there does not appear to be the type of exclusive control required by *Peck*¹ to constitute the rental of tangible personal property (software). Additionally, payments to *** are not fixed or based on software usage, rather, they are based on the dollar amount of successful payments generated. Thus, payments may vary month by month. That being the case, *** is not renting software. **** is not conducting any taxable activity for Arizona TPT purposes and is therefore not subject to the TPT.*

SUMMARY OF FACTS: The following is a summary of the relevant facts based on your letter dated June 1, 2016, and subsequent correspondence with the Department on July 22, 2016, July 26, 2016 and August 5, 2016, together with copies of the relevant contract pages describing the product lines offered by ***:

*** is a subscription billing and reoccurring payment provider. It is located outside of Arizona, but has clients in Arizona. It processes electronic payment transactions on a time determined basis on behalf of its clients for their products and services sold to end user

¹ *State Tax Commission v. Peck*, 106 Ariz. 394, 476 P.2d 849, discussed later.

consumers. Products and services offered by ***'s clients include content site subscriptions, newsletter fees, club dues or even recurring donations. *** has several offerings in Arizona, Line A, a billing product, Line B, a 'salvage-decline' product, and Line C which bundles Lines A and B as a single offering.

Line A. In relation to Line A, *** obtains end user customer information from its clients. This includes payment amount, payment frequency and personally identifiable information including name, address and payment card information. ***'s clients upload the end user customer information to ***'s servers through the use of an Application Program Interface ("API"). *** initiates the billing and payment process with its clients' payment processor² using this information. The initiation process is done according to the time interval (e.g. weekly, monthly etc.) requested. In addition to payment processing initiation, *** provides its clients with different types of reports that detail its transaction processing activity and results or analyses the effectiveness of its client's various promotions and marketing campaigns. Some of the reports are automatically generated by ***'s system and others are manually prepared by ***'s representatives.

Line B. In relation to Line B, *** re-processes payment request transactions that were previously declined by its client's payment processor. In this case, the client normally has its own billing and payments platform and initiates the payment request process itself. *** uses proprietary methods to attempt to re-process the declined payment request transactions in order to obtain payment.

Line C. Line C bundles Lines A and B as a single offering. In relation to Line C, *** initiates its clients billing/payments processes and also re-submits any transactions that are declined. When Lines A and B are bundled as Line C, the invoice may either be presented as one non-itemized price or each may be separately stated on the invoice.

Generally, clients are able to upload end user customer information to ***'s servers via the API which is cloud based. The API encrypts the end user customer payment data to regulatory standards and securely transmits that data over the internet to ***'s servers.³ *** does not specifically charge for the use of the API. Clients need only upload the customer end user data once; *** will continue to process requests without any further input from clients. However, if there are any changes that must be made to the data on ***'s servers, clients must update it so that ***'s servers have current information. *** stores the end user

² Each of ***'s clients has a separate agreement with a payment processor. Payment processors are separate third parties unrelated to ***. *** is not itself a payment processor.

³ The API is a necessary component of ***'s internal controls related to the security standards developed by the Payment Card Industry Security Standards Council.

consumer payment data on its servers for continuous use in processing the electronic payment transactions on behalf of its clients.

***'s clients are able to access transaction data through a web-based portal ("Portal"). The Portal allows clients to view transaction data and reporting. Clients are not separately charged for the use of or access to the portal. Some reports are system generated and others are prepared manually by ***'s employees.

Payment processing companies remit successful payments to the clients directly. *** is not paid by the payment processing companies. *** is paid separately by its clients. Although *** is not paid directly by payment processing companies, it is aware of how much money is remitted to its clients by the payment processors as a result of the reports of successful payments. *** sends its clients invoices based on that information. ***'s billing of its clients vary based on the size and scope of the work involved. However, fees are generally based on the dollar amount of successful billing transactions in a particular time frame (e.g. monthly). ***'s gross income derived from each line is approximately 33%. If clients do not pay *** as agreed, *** will not initiate payment processing requests with payment processing companies in subsequent months and *** will disable access to the API and Portal.

DISCUSSION & LEGAL ANALYSIS:

Arizona's TPT differs from the sales tax imposed by most states. It is a tax on the privilege of conducting business in the State of Arizona. Differing from a true sales tax, the TPT is levied on income derived by the seller, who is legally allowed to pass the economic expense of the tax on to the purchaser. The Arizona TPT is imposed under fifteen separate business classifications including the personal property rental and retail classifications. Those classifications impose the TPT on the rental and sale of *tangible personal property* respectively.

A.R.S. § 42-5001(17) defines "tangible personal property" as "personal property which may be seen, weighed, measured, felt or touched or is in any other manner perceptible to the senses."

Consistent with the broad definition of tangible personal property as provided in A.R.S. § 42 5001(17), there is longstanding precedent in case law for that definition to be applied to subjects other than physical goods, such as electricity, electronic delivery of software, and music played from a jukebox. Significantly, in applying the broad definition of tangible personal property, numerous courts have concluded that software is tangible personal

property and subject to tax.⁴ In *Wal-Mart Stores, Inc. v. City of Mobile*,⁵ for example, the court held software was tangible personal property because the physical copy of the code was on some tangible medium.⁶

In this case, the API and the Portal are considered software and so tangible personal property is implicated. As a result, it must be determined whether *** is selling software, renting software or engaging in a non-taxable activity.

A.R.S. § 42-5061 imposes the TPT under the retail classification. The retail classification is comprised of the business of selling tangible personal property at retail. A.R.S. § 42-5001(V)(b)(3) defines “selling at retail” as a sale for any purpose other than for resale in the regular course of business. A.R.S. §42-5071 imposes the TPT on the business of leasing or renting tangible personal property for a consideration. The tax base for both the retail and rental classifications is the gross proceeds of sales or gross income derived from the business. All sales or rentals of tangible personal property are subject to the TPT unless specifically exempted or excluded by statute.

In a case where a taxpayer grants its customer the right to the software for a perpetual duration (i.e. a sale), it is appropriately taxable under the retail classification. If, on the other hand, a taxpayer grants its customer the right to use software for a fixed period of time at a fixed amount, it is appropriately taxable under the personal property rental classification. Your indication that *** charges its clients a periodic fee based on the dollar amount of processed transactions coupled with the fact that access to the API and portal are discontinued if clients do not pay as agreed means that ***’s clients are not granted software access for a perpetual duration. Therefore, ***’s activities would not be considered retail sales.

Because a retail sale is not involved, the next question is whether the use of software in ***’s activities can be considered the rental of tangible personal property or some other non-taxable activity.

⁴ See, e.g., *Comshare, Inc. v. United States*, 27 F.3d 1142 (6th Cir.1994) (income tax credit); *Wal-Mart Stores, Inc. v. City of Mobile*, 696 So.2d 290 (Ala.1996) (sales tax); *Andrew Jergens Co. v. Wilkins*, 109 Ohio St.3d 396, 848 N.E.2d 499 (2006) (property tax); Ruhama Dankner Goldman, Comment, From Gaius to Gates: Can Civilian Concepts Survive the Age of Technology?, 42 Loy. L.Rev. 147, 158 (1996) (“the trend in classification of computer software has been to classify it as tangible personal property”).

⁵ 696 So.2d 290 (Ala.1996).

⁶ *Walmart*, 696 So. 2d at 291, citing *South Cent. Bell Tel. Co. v. Barthelemy*, 643 So.2d 1240, 1244–45 (La.1994).

The Arizona Supreme Court in *State Tax Commission v. Peck*,⁷ set out guidelines for determining whether a particular activity is considered personal property rental. It adopted a dictionary definition of the verb “to rent”. It noted:⁸

Webster's Third International Dictionary defines the verb “to rent” as “(1) to take and hold under an agreement to pay rent,” or “(2) to obtain the possession and use of a place or article for rent.

The court determined that:⁹

There is no question that when customers use the equipment ... such customers have an exclusive use of the equipment for a fixed period of time and for payment of a fixed amount of money... the customers themselves exclusively control all manual operations necessary to run the machines. In our view such exclusive use and control comes within the meaning of the term “renting” as used in the statute.

By contrast, the case of *Energy Squared v. Arizona Department of Revenue*,¹⁰ determined that the taxpayers were providing a professional service through the use of tanning equipment. In holding that the taxpayers were not renting tangible personal property but rather were rendering personal services through the use of equipment that remained effectively theirs, the Court noted:¹¹

The taxpayer's customers do not “themselves exclusively control all manual operations necessary to run” the tanning beds or booths in question... the “exclusive use and control” by the customer that *Peck* determined to be the essence of “renting” within the taxing statute is not present here.

From the above cases, the critical question is whether ***'s customers gain sufficient control and use of its software (the API and the Portal) to constitute the rental of tangible personal property. The granting or non-granting of a software license is not definitive of that question because a software license is dissimilar to other arrangements that fall under

⁷ 106 Ariz. 394, 476 P.2d 849

⁸ *Id.* at 396, 476 P.2d at 851.

⁹ *Id.*

¹⁰ 56 P.3d 686, 203 Ariz. 507

¹¹ *Id.* at 689; 203 Ariz. at 510.

the general license nomenclature used for leases and rentals of tangible personal property. Additionally, as may be gleaned from *Peck*, actual possession of the property by its transfer to the customer is not essential for a finding of control.

In this case, *** initiates the payment requests on behalf of its clients after they submit end user customer data to *** through the API. Additionally, once submitted clients need not upload any further information to the API unless changes to the current data stored on ***'s servers are necessary. After the end user customer information is uploaded, payment requests are made continuously and automatically based on the information on ***'s servers without any further input from clients unless updates or changes are needed. After the payment requests are made by ***, the payment processor either processes the requests by issuing payments or informs the parties that the payment request is declined. When a payment is declined, *** is able to send subsequent requests for payment using its proprietary methods for those clients that have opted to pay for Line B (or Line C). No matter which line clients sign up for, they are able to see manual or system generated reports and analysis of the results of the requests made on their behalf by logging into ***'s Portal.

Both *** and its clients use the software; *** stores end user customer payment data on its servers after it is uploaded by the client, then it uses that information to request payment. In addition, *** updates information on the portal either manually or automatically so that the client may see the status of payments processed and other analytical information. Thus, there does not appear to be the type of exclusive control required by *Peck* to constitute the rental of tangible personal property (software). Additionally, payments to *** are not fixed or based on software usage, rather, they are based on the dollar amount of successful payments generated. Thus, payments may vary month by month. *That being the case, *** is not renting software. *** is not conducting a taxable activity for Arizona TPT purposes and is therefore not subject to the TPT.*

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 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.