



PRIVATE TAXPAYER RULING LR 20-011

Douglas A. Ducey
Governor

Carlton Woodruff
Director

September 1, 2020

Thank you for your letter dated December 16, 2019, requesting a private taxpayer ruling (“PTR”) on behalf of *** (“Taxpayer”), a 501(c)(6) federally exempt organization. Specifically, you requested a determination of whether sales of individual memberships (“Memberships”) are subject to taxation pursuant to the Arizona transaction privilege tax (“TPT”) statutes.

Pursuant to Arizona Revised Statutes (“A.R.S.”) § 42-2101, the Arizona Department of Revenue (“Department”) may issue private taxpayer rulings to taxpayers and potential taxpayers on request.

ISSUE:

Whether, as a federally recognized 501(c)(6) nonprofit organization, Taxpayer’s gross income derived from Membership sales is subject to TPT.

RULING:

The Department rules as follows:

Taxpayer’s business is focused on professional development and almost half of Taxpayer’s members do not purchase certification courses from Taxpayer. Thus, applying the *Holmes & Narver* test to Taxpayer’s sale of Memberships results in a nontaxable separate line of business from Taxpayer’s taxable retail sales of tangible personal property and the gross income derived from the sale of Memberships is not subject to TPT.

SUMMARY OF FACTS:

The following facts are a summary based on your ruling request dated December 16, 2019, as well as additional information provided January 10, 2020, January 23, 2020, April 20, 2020, and June 18, 2020:

Taxpayer is a corporation organized under Internal Revenue Code (“I.R.C.”) § 501(c)(6), as a not-for-profit professional membership association for *** and is the issuing body for the *** (“****”) [a

professional] certification. Taxpayer is headquartered in *** with *** chapters internationally serving *** members. Taxpayer has a local chapter in Arizona and has physical nexus with the state. Taxpayer works to advance and develop the careers of *** through its globally recognized standards; certifications; resources; tools; academic research; publications; professional development courses; and networking opportunities.

Annual membership (“Paid”) costs ***. Membership benefits include certification status tracking, the ability to download the *** for free,¹ digital tools and templates, discounts on certification courses, and access to certain Taxpayer publications. Taxpayer also offers a free membership (“Free”) with limited access to [tools],² ***,³ ***,⁴ ***⁵ and *** videos.

Taxpayer 2018 Revenue	
Certification Courses ⁶	32.20%
E-Learning Courses ⁷	02.07%
Publications and Other Tangible Personal Property ⁸	09.86%
Membership Fees ⁹	40.00%
Advertising, Sponsorships and Conferences ¹⁰	15.87%

Taxpayer’s email from January 21, 2020 provided that “[a]s of January 2020, [Taxpayer] has *** certification preparation courses and they are all exclusively to help prepare one for the ***. The most popular course, ***, is responsible for 99% of the volume. This course is only offered in

¹ ***.

² Access to *** by a free membership is limited to a few *** and a paid membership is required for access to the majority of the ***.

³ *** is a free networking tool available to paid members and nonmembers alike. Email from ***, to ***, Arizona Department of Revenue, (Jan. 21, 2020 13:20 AST) (on file with author).

⁴ *** is a free *** available to paid members and nonmembers alike. *Id.*

⁵ *** is a Taxpayer publication available to ***. *** (accessed January 27, 2020). ***. *** (accessed January 27, 2020).

⁶ Email from ***, Manager, to ***, Arizona Department of Revenue, (Jan. 28, 2020 11:03 AST) (on file with author).

⁷ *Id.*

⁸ *Id.*

⁹ *Id.*

¹⁰ *Id.*

eLearning on Demand format, not live. [Taxpayer] MEMBERS PAY US\$*** and non-members pay \$***.” These courses are available to all members and nonmembers—including those in Arizona—and a purchase grants the member or nonmember a lifetime access to the course.

Additionally Taxpayer email provided the following table:

Estimated Online Content Usage Information per Member (2019)	
Online Learnings	2.00%
Webinars/Virtual Events Live vs. On-Demand	10.8% live vs. 89.20% on-demand
Template Downloads per Member	7.74
On-Demand Webinar Videos per Member	7.74
Virtual Event Attendance per Member	0.38

In summary, a paid membership is not required to enroll in the certification preparation courses and ultimately be certified as a *** by Taxpayer. Taxpayer’s website provides that “***.”¹¹

Current Arizona Membership and Certifications		
	Membership	Percentage of Total
Total Current Members in AZ	6,095	100%
Current AZ Members with 1 Cert	3,500	57%
Current AZ Members with 2 or More Certs	207	3%
Current AZ Members with No Current Certifications	2,388	39%

¹¹ *** , (accessed January 27, 2020).

DISCUSSION AND 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, A.R.S. § 42-5008 levies TPT on the income derived by the seller, who is legally allowed to pass the economic expense of the tax to the purchaser. However, the seller is ultimately liable to Arizona for the tax. The Arizona TPT is imposed under 16 separate business classifications and the tax base is presumed to be the gross proceeds of sales and gross income derived from the taxable business activity. A.R.S. § 42-6102(A) provides that, once authorized, county taxes are levied in the same manner as the state's TPT provisions. Thus, all sales subject to TPT are also subject to applicable county excise taxes.

Retail Classification

A.R.S. § 42-5061 imposes TPT under the retail classification. The retail classification is comprised of the business of selling tangible personal property at retail. The tax base for the retail classification is the gross proceeds of sales or gross income derived from the business. All sales of tangible personal property are subject to the TPT under the retail classification unless a specific statutory deduction or exclusion exists.

Sales by a 501(c)(3) nonprofit organization are exempt from TPT under A.R.S. § 42-5061(A)(4). However, this exemption does not extend to sales made by any other nonprofit organized under Internal Revenue Code section 501(c). Thus, as a 501(c)(6) nonprofit organization, Taxpayer's gross proceeds derived from the selling of tangible personal property, including physical or digital tangible personal property, are subject to state and county TPT.

City Tax

It is important to note, the imposition of city privilege taxes is separate and distinct from the state's TPT and accompanying county excise taxes. As with the state's TPT, city privilege taxes are imposed on the vendor for the privilege of engaging in business in the city. The Model City Tax Code ("MCTC") was created in order to impose and administer city privilege taxes. Similar to Arizona's TPT, city privilege taxes are imposed "upon persons on account of their business activities." See MCTC § - 400(a)(1). All Arizona cities follow the MCTC in the imposition of their privilege tax based upon their local ordinances. However, certain options exist, allowing each city to alter or qualify the imposition of its privilege tax.¹²

¹² The MCTC can be found online at <https://modelcitytaxcode.az.gov>.

Nonprofit Organizations – City

MCTC § -270(b) provides that, in all classifications, other than retail sales which is superseded by A.R.S. § 42-6017, a federally exempt organization is deemed not subject to the city privilege tax.¹³ “Transactions which, if conducted by any other person, would produce gross income subject to the tax under this Chapter shall not be subject to the imposition of such tax if conducted entirely by a federally exempt organization . . .”¹⁴

A federally exempt organization is defined as “an organization which has received a determination of exemption, or qualifies for such exemption, under 26 U.S.C. Section 501(c) and rules and regulations . . .”¹⁵

Retail Sales - City

A.R.S. § 42-6017 addresses the city privilege taxes in relation to the retail classification. It provides that “[e]xcept as provided in this section, section 42-5061 supersedes all city or town ordinances or other local laws insofar as the ordinances or local laws now or hereafter relate to the taxation of business activities classified under section 42-5061.” That section also provides certain exceptions where a city may exempt or tax specific items that are not taxable or exempt by the state provisions.

Discussion

Taxpayer is in the business of developing *** professionals through the sale of certification courses, e-learning courses, publications, books, merchandise, advertising and sponsorships, and local chapters.

The Arizona Supreme Court held that TPT is measured by all of the business activity of a taxpayer rather than merely a part of it.¹⁶ Nevertheless, the Court later found that a person’s activities may constitute more than one business and the taxpayer would be obligated to pay the appropriate tax on each business.¹⁷ For example, the gross income derived from Taxpayer’s sale of tangible personal

¹³ Please note, this section exempts a nonprofit organization from paying TPT on the gross income derived from the nonprofit’s business activities.

¹⁴ MCTC § -270(c) (2019).

¹⁵ *Id.* § -270(a)(1).

¹⁶ *Duhame v. State Tax Commission*, 65 Ariz. 268, 179 P.2d 252 (1947).

¹⁷ *Trico Elec. Co-op v. State Tax Comm’n*, 79 Ariz. 293, 297-98, 288 P.2d 782, 784 (1955).

property is taxable under the retail classification and the sale of advertising and sponsorships is taxable by the cities under advertising, unless otherwise excluded or deducted.¹⁸

In 1976, the Arizona Supreme Court again addressed the principle in *Holmes & Narver*.¹⁹ After stating that not all business is the subject of TPT (*i.e.*, only those businesses specifically set forth in the statutes), the Court set forth the following three-part test to determine when a service is not part of the primary business:

1. The portion of the business that is the service in issue can be readily ascertained without substantial difficulty;
2. The revenues from the service, in relation to the taxable revenues of the business, are not inconsequential; and
3. The service cannot be said to be incidental to the other taxable activity.

In 1995, the Arizona Court of Appeals elaborated on the *Holmes & Narver* test, noting that “when the amount involved is not minimal, when it can be easily calculated, and when the service it relates to is not an integral part of the main business, the main and ancillary services can be separated for tax purposes.”²⁰ The court determined that income from concededly nontaxable activity (the sale of gasoline) was part of the personal property rental classification tax base for city tax purposes. In so holding, the Court of Appeals stated:

In summary, we conclude that because every Budget car rental contract includes a refueling charge, the charge is an integral part of Budget’s car rental business. Because most customers return with a full gas tank, thus avoiding the refueling charge, the charge accounts for a minimal percentage of Budget’s car rental business. Accordingly, refueling charges paid to Budget are taxable as gross income from the car rental business.²¹

Generally, a taxpayer’s receipts from payments for various services offered in addition to another business activity could nevertheless be considered part of the business’s taxable receipts, when the services are interwoven in and are an integral part of the taxpayer’s business activity. Or unless otherwise excluded by statute.

¹⁸ See A.R.S. § 42-5061 and MCTC § -410.

¹⁹ *State Tax Comm’n v. Holmes & Narver, Inc.*, 113 Ariz. 165, 548 P.2d 1162 (1976).

²⁰ *City of Phoenix v. Ariz. Rent-A-Car Sys.*, 182 Ariz. 75, 893 P.2d 75 (1995).

²¹ *Ariz. Rent-A-Car Sys.*, at 80.

In *Walden Books* the court addressed a sale of memberships in addition to a business' retail sales.²² Walden Books Co., also known as Waldenbooks, sold books, periodicals and related merchandise throughout the United States.²³ Waldenbooks introduced a membership program referred to as the Preferred Reader Program, which provided discounts on the purchase of books and other merchandise and other privileges.²⁴ Waldenbooks argued that: (1) a membership was a sale of an intangible and not subject to TPT under the retail classification; and (2) the membership program was a nontaxable service in addition to a retail sale.²⁵ The court asked Waldenbooks if the membership was made available "in order to stimulate retail sales."²⁶ Waldenbooks admitted that it was, but clarified that they believed it would increase the sale of merchandise by developing customer loyalty and repeat business through the discount and other benefits offered through the membership.²⁷ The Department argued that under *Holmes & Narver* "the retail tax base is not restricted to receipts from sales of tangible personal property at retail, but rather comprehends all receipts from the seller's business activities unless certain other conditions are met."²⁸

The court stated that applying *Holmes & Narver* to the services in addition to a retail sale deduction was not appropriate as applying the test would "significantly amend the statute, which is a legislative function . . . [w]e therefore hold that the *Holmes & Narver* test is inapplicable in determining taxability of services under the retail classification."²⁹ However, the court said that it would be proper to apply *Holmes & Narver* to the issue of the taxability of an intangible discount purchase right, and whether the membership fees attributable to the discount part of the program constituted part of the gross income of the retail sales.³⁰ Ultimately, the court concluded that the taxpayer failed all three elements to the *Holmes & Narver* test and the gross income derived from the membership was found to be included in the taxpayer's taxable income.

Similar to *Walden Books*, Taxpayer derives income from the sale of certification videos, e-learning videos, books, etc., ("merchandise") which is taxable under the retail classification. Taxpayer also derives income from the sale of Memberships. The gross income derived from the sale of Memberships is taxable unless it is found to be a nontaxable separate line of business using the *Holmes & Narver* test.

²² *Walden Books Co., v. Ariz. Dep't. of Revenue*, 198 Ariz. 584, 12 P.3d 809 (Ct App. 2000).

²³ *Id.* at 585, 810.

²⁴ *Id.*

²⁵ *Id.* at 586, 811.

²⁶ *Id.* at 585, 810.

²⁷ *Id.*

²⁸ *Id.* at 587, 812.

²⁹ *Walden*, at 587, 812.

³⁰ *Id.*

In applying *Holmes & Narver* to Taxpayer's sale of Memberships, first, it must be easily determined which part of the business is the sale of Memberships and which part is the sale of taxable merchandise. Taxpayer markets and sells the Memberships separate from all other sales, and the books and records of the company are maintained as to easily distinguish the revenue generated from each line of business.

Secondly, the revenue from the sale of the memberships must not be inconsequential. No court has established a bright line threshold percentage to determine if the revenues are inconsequential or not. However, by way of a guideline "[i]n *Holmes & Narver*, the court considered design fees of 43% to be significant. By contrast, the percentage found by the court to be inconsequential in *Arizona Rent-A-Car Systems, Inc.* was approximately 2% [and a] percentage of less than 6% suggests that Taxpayer was not engaged in a separate design business."³¹

Taxpayer's total percentage of gross income derived from the sale of memberships is 40% of the annual revenue. Thus, the gross income derived from the sale of memberships are significant and within the boundaries established by the Court as to be considered consequential.

Finally, the sale of memberships must not be incidental to the rental of the certification videos and the sale of other items of tangible personal property. Incidental is defined as integral or inseparable from the principal business and interwoven into the business operation in such a manner that it is an essential part of the major business.³² Purchase of the Membership is not required in order to purchase the certification courses, or any other merchandise sold by Taxpayer, and vice versa. Thus, the sale of memberships are not incidental to becoming certified by Taxpayer as a significant portion—39% to be exact—of Taxpayer's Arizona members do not even complete a certification and only 3% complete more than one certification.³³ Rather, it appears that a large portion of the members pay for the Membership primarily to gain access to the professional development services provided with the membership such as networking, job opportunities, local chapters, development tools, and mastering new skills through free webinars and events.

Conclusion

Taxpayer's status as a federally recognized 501(c)(6) nonprofit organization is not determinative as to whether the gross income derived from Membership sales to Arizona customers is taxable.

³¹ Arizona Department of Revenue, *The Director's Review of the Decision of the Administrative Law Judge*, Case No. 200200180-S (2003).

³² *Advo System, Inc., v. City of Phoenix*, 189 Ariz. 355, 942 P.2d 1187 (Ct. App. 1997) (finding mailing services to be an integral part of an advertisement business as a matter of fact and as a matter of definition under the city tax code).

³³ Email from ***, to ***, Arizona Department of Revenue, (June 12, 2020 07:44 AST) (on file with author).

Rather, separately from the taxable sale of merchandise at retail, Taxpayer's is also engaged in a service of professional development through the Membership. Thus, Taxpayer's Membership is a nontaxable separate line of business, and the gross income derived from this service is not taxable.³⁴

This response is a private taxpayer ruling and the determinations herein are 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 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.

³⁴ Even if this ruling had found the sale of memberships to be taxable by the state and county, the sale of memberships would still not be taxable by the cities as an exempted organization under MCTC § -270.