STATE OF ARIZONA
Department of Revenue

Katie Hobbs
Governor

Robert Woods
Director

November 6, 2024

Via email: [redacted]

[redacted]
Phoenix, AZ 85007

Dear [redacted]:

Thank you for your letter of September 30, 2024, on behalf of the [redacted]. [redacted] letter provided comments to the Department's draft ruling on nexus and sourcing, and raises several objections to the draft's contents.

The Department's responses and resolutions follow:

1. Nexus as to municipalities

[redacted] first objects to the first full paragraph on page six of the draft, which states:

> A business does not need to have nexus with each municipality within Arizona to be subject to city privilege taxes by such municipality. A business that has nexus with the State of Arizona thereby has nexus with all municipalities within the State and is subject to all applicable city privilege taxes.

[redacted] contends that "[a] business that has substantial physical nexus in one city does not mean it has nexus in every city" and that "[i]f the paragraph is intended to address economic nexus . . . then the business has nexus once the threshold . . . is exceeded and only to those cities in which the sales can be sourced."

The Department disagrees with the assertion that substantial nexus by physical presence or economic nexus must be established per municipality, which is unsupported by *Wayfair*[1] and which could lead to unintended consequences. For example, a retailer with $99,000 in sales in several municipalities would be held to lack economic nexus despite having well over $100,000 in total sales, while a company with a light physical footprint in several municipalities could escape substantial nexus by physical presence if each individual physical footprint was de minimis. That is not the law.

[1] *South Dakota v. Wayfair, Inc.*, 585 U.S. 162 (2018).

The Department does, however, recognize that its draft language could induce an overbroad reading. It will therefore amend the paragraph as follows (see change in italics):

> A business does not need to have nexus with each municipality within Arizona to be subject to city privilege taxes by such municipality. A business that has nexus with the State of Arizona thereby has nexus with all municipalities *to which its sales are sourced* within the State and is subject to all applicable city privilege taxes.

2. Sourcing discussion

[redacted] also objects to the draft's sourcing discussion, stating that "there is little discussion on the issue" and thus "recommend[ing] the draft elaborate on the sourcing rules . . . or eliminate the sourcing discussion altogether."

The Department agrees that the draft's sourcing discussion is limited. (In fact, the Department is preparing another draft ruling solely on sourcing.) But the question of sourcing often does arise directly after the question of nexus is resolved, and so it seems to us proper to offer some basic guidance on the subject in this ruling. Thus, keeping in mind that a fuller treatment on sourcing is to be given in a later ruling, and keeping also in mind the possibility of amendments to the sourcing statute, which counsels present restraint, the Department has determined to retain its discussion in the present ruling.

3. Example scenarios

[redacted] further objects to certain example scenarios provided in the draft ruling. First, it objects to examples one and two, which are these:

> 1. In 2021, an out-of-state company with no substantial nexus by physical presence with Arizona derived $250,000 in gross income from monthly subscriptions to its cloud-based software to Arizona customers. The company would not have economic nexus with Arizona from its personal property rentals because only income derived from the retail classification, and not the personal property rental classification, go towards the economic nexus thresholds.
> 2. The same out-of-state company from Example 1, above, but in addition to its personal property rental income, also had gross income derived from retail sales of software to Arizona customers totaling $150,000 in 2021. The company would have substantial nexus with Arizona because its retail sales

> exceed the economic nexus thresholds. The tax is imposed only on the retail sales.

[redacted] contends that "[i]n both examples 1 & 2, the company would have physical nexus under the rental classification from the rental of tangible personal property (SaaS) as a result of the *ADP* ruling." We disagree that *ADP*[2] requires that conclusion. The *ADP* court held that software is tangible personal property.[3] It did not hold that software is physical property, nor did it even consider the nexus consequences of software.

Consider too the consequences if the Department were to read *ADP* as ruling that rental software establishes substantial nexus by physical presence: for example, an out-of-state company providing rental software would be held taxable from the first dollar generated by its rentals while a similarly situated out-of-state retail seller of software with $99,000 in retail sales of software would escape taxation. And were we to conclude from *ADP* that software's use in Arizona alone creates substantial nexus by physical presence, then nearly every company with a website accessible from Arizona would have substantial nexus by physical presence in Arizona, including retailers with retail websites. Such a result would make Arizona's economic nexus statute superfluous, and thus, be an incorrect interpretation of its provisions. Because we do assert that the conclusions drawn in them are correct, the Department makes no changes to examples one and two.

[redacted] then objects to example five, which reads as follows:

> A Utah-based company rents a physical server to an Arizona customer. The server is located in Arizona. Because the server is located in Arizona, the Utah-based company has substantial nexus by physical presence with the State and its leases of software to Arizona customers would be subject to TPT.

[redacted] asserts that the example is objectionable because "[a] company renting only one server to an Arizona customer may be considered *de minimis*." We disagree. Arizona Administrative Code R15-5-2002(B)(2) provides that an activity or factor that establishes a retailer's physical presence within Arizona includes "own[ing] or leas[ing] real or personal property in Arizona." And so we make no changes to example five.

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[2] *ADP, LLC v. Ariz. Dep't of Revenue*, 254 Ariz. 417 (Ct. App. 2023).
[3] *See id.* at 422 ¶ 10.

4. Use tax discussion

[redacted] final objection concerns the draft's treatment of use tax. [redacted] "recommend[s] any reference to a seller's obligation to collect and/or remit use tax be removed or rephrased to reference a 'purchaser' instead." But that limitation would be too limiting: a vendor may choose to assume responsibility for collecting and remitting use tax (as explained on page five of the draft ruling), and a vendor so doing does indeed have an obligation to collect and remit use tax, just as a party consenting to a court's jurisdiction has an obligation to abide by the court's judgment. The Department therefore makes no changes to its use tax discussion.

The Department appreciates your comments and your participation in the notice-and-comment process. If you have any additional questions, please do not hesitate to reach out again.

Sincerely,

[redacted]

[redacted]
Arizona Department of Revenue