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ARIZONA TRANSACTION PRIVILEGE TAX RULING

TPR 24-__

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Date Proposed: Aug. 12, 2024

Date Final:

Issue:

1. How does Arizona determine whether an out-of-state business has “substantial nexus” with the state for purposes of imposing Arizona’s transaction privilege tax (“TPT”), county excise tax, use tax, and city privilege taxes?
2. Once substantial nexus is established, how should an out-of-state business determine the appropriate tax rate for calculating transaction privilege tax (i.e., “sourcing” rules)?

Ruling Summary:

1. Out-of-state businesses that have substantial nexus with Arizona are subject to TPT, county excise tax, use tax, and city privilege tax. Substantial nexus can be established by physical presence (applicable for all classifications) or economic nexus (applicable to the retail classification only) with the State.

An out-of-state business establishes substantial nexus by physical presence with Arizona by non-transitory activities performed within the State on the business’ behalf that are significantly associated with the business’ ability to establish and maintain a market in this State for its sales. *See Arizona Department of Revenue v. O’Connor, Cavanagh,*

Anderson, Killingsworth & Beshears, P.A., 192 Ariz. 200, 205 (Ct. App. 1997) (citing *Tyler Pipe Industries, Inc. v. Washington State Department of Revenue*, 483 U.S. 232 (1987)); see also Arizona Administrative Code (“A.A.C.”) R15-5-2002(B). Businesses with substantial nexus by physical presence with Arizona are treated the same as local businesses, meaning they are taxable on the first dollar derived from the taxable business activity.

Remote sellers¹ (when not selling through a marketplace facilitator), and marketplace facilitators² (for sales on its own behalf and on behalf of at least one marketplace seller³) have economic nexus with Arizona if their annual gross proceeds of retail sales or gross income derived from retail sales to customers in the State, prior to any statutory deductions therefrom, are more than the thresholds set out in Arizona Revised Statutes (“A.R.S.”) §§ 42-5044(A)(1)(a)-(c), (2)⁴.

2. If substantial nexus by physical presence exists and TPT applies, a business is then subject to TPT under all classifications and may rely on Arizona’s “sourcing” rules to determine the appropriate tax rate for each classification. See A.R.S. §§ 42-5034, -5040; see also *Transaction Privilege Tax Ruling TPR 20-2*⁵. If only economic nexus exists, without substantial nexus by physical presence, a business is then subject to TPT under the retail classification. *Id.*

Applicable Law and Discussion:

Transaction Privilege Tax:

Arizona’s TPT is a tax on the privilege of conducting business in the State of Arizona. TPT is levied on the business rather than the customer. The business may pass the burden of the tax on to its customer; however, the business is ultimately liable to Arizona for the tax. TPT is imposed under sixteen business classifications, which are listed in Article 2, Chapter 5, Title 42 of the Arizona Revised Statutes.

¹ Remote seller, as defined in A.R.S. § 42-5001(16)

² Marketplace facilitator, as defined in A.R.S. § 42-5001(9)

³ Marketplace seller, as defined in A.R.S. § 42-5001(10)

⁴ Under A.R.S. § 42-5044(A)(1)(c), (2), the threshold for the calendar year 2021 and for each calendar year thereafter is \$100,000 for both remote sellers and marketplace facilitators.

⁵ TPR 20-2 is available on the Department’s website at <https://azdor.gov/legal-research/rulings/tpr-20-2>.

A business does not have to have a physical location in Arizona to be subject to TPT. An out-of-state business may be subject to TPT if the business is engaged in an activity within Arizona under one of the taxable business classifications *and* it has a “substantial nexus by physical presence” with Arizona, as explained below. Remote sellers and marketplace facilitators without substantial nexus by physical presence may still be subject to TPT if they have economic nexus with the State (i.e., when their annual gross proceeds of retail sales or gross income derived from retail sales to customers in the State, prior to any statutory deductions therefrom, are more than the thresholds set out A.R.S. §§ 42-5044(A)(1)(a)-(c), (2), explained further below).

Substantial Nexus:

Under the Dormant Commerce Clause and the Due Process Clause under the U.S. Constitution’s Fourteenth Amendment, a business must have substantial nexus with a State in order to be subject to taxation by such State. Prior to the development and implementation of the internet and other modern digital sales tools in the marketplace, various court rulings, including the U.S. Supreme Court ruling in *Quill Corp. v. North Dakota*, interpreted such clauses to require a physical presence by a business within the State wishing to impose taxes on such business (i.e., substantial nexus by physical presence). 504 U.S. 298, 312 (1992). However, in *South Dakota v. Wayfair, Inc.*, the U.S. Supreme Court ruled that a business’s *economic nexus* with a State is sufficient for a State to impose tax upon a business without violating the Dormant Commerce Clause or the Due Process Clause of the Fourteenth Amendment. 585 U.S. 162 (2018).

The *Wayfair* Court, observing that “[m]odern e-commerce does not align analytically with a test that relies on the sort of physical presence defined in *Quill*,” reasoned that “when the day-to-day functions of marketing and distribution in the modern economy are considered, it is all the more evident that [*Quill*’s] physical presence rule is artificial in its entirety” and that the “Court should not maintain a rule that ignores . . . substantial virtual connections to the State.” *Id.* at 180–81. It accordingly held that a seller whose “quantity of business could not have occurred unless the seller availed itself of the substantial privilege of carrying on business in” a state has nexus with such a state and therefore may be taxed by that state. *Id.* at 188. Accordingly, a State is able to tax a business that has substantial nexus by physical presence *or economic nexus* without violating the Dormant Commerce Clause or the Due Process Clause of the Fourteenth Amendment.

Substantial nexus by physical presence:

The *Wayfair* ruling left in place the existing law that a business’s physical presence (i.e., substantial nexus by physical presence) in a state subjects it to taxation by such state. A business

establishes substantial nexus by physical presence within Arizona by activities performed in this state by itself directly or on its behalf by agents or independent contractors that are significantly associated with the retailer's ability to establish and maintain a market in this state for its sales⁶. Substantial nexus by physical presence is applicable to all business activities taxable under all TPT classifications—a business that establishes a physical presence in Arizona shall continue to be responsible for reporting and remitting TPT for the duration of the physical presence. See A.A.C. R15-5-2002(E). Businesses with substantial nexus by physical presence with Arizona are taxable on the first dollar derived from the first taxable business activity performed after substantial nexus by physical presence is established, and are subject to TPT for all business activities under all TPT classifications performed within the state or with Arizona customers.

A.A.C. R15-5-2002 further addresses the imposition of TPT on businesses with substantial nexus by physical presence with Arizona, including listing non-exclusive examples of business activities and factors that, by themselves or in conjunction with others, may establish substantial nexus by physical presence for the business, including owning or leasing real or personal property located within the state, maintaining an inventory of products within the state at its own direction and control, and by delivering its merchandise or goods into the state on an ongoing basis using vehicles it owns or leases. See A.A.C. R15-5-2002(B)(1)-(4).

Further, other local activities performed by a business's employees, agents, representatives, contractors, or affiliated persons that enable the business to maintain and improve its name recognition, market share, or sales volume, goodwill, and individual customer relations may establish physical presence if the activities are not of a transitory nature. *Id.* at R15-5-2002(B)(5). A business's activities in Arizona are not of a transitory nature if such activities generate gross receipts, are ongoing, and are regularly conducted from within the state. *Id.* at R15-5-2002(D). Alternately, a retailer's activities in Arizona are not of a transitory nature if such activities generate gross receipts and the business regularly conducts the same business activities outside of Arizona. *Id.* Subsection (D) of A.A.C. R15-5-2002 provides various non-exclusive examples of business activities and whether they are considered transitory in nature or not. Additional examples are provided in this Ruling, below.

Economic nexus:

⁶ The Arizona Court of Appeals has applied this standard in two cases: *Arizona Department of Revenue v. Care Computer Systems, Inc.*, 197 Ariz. 414, 416 (Ct. App. 2000), and *Ariz. Dep't of Revenue v. O'Connor, Cavanagh, Anderson, Killingsworth & Beshears, P.A.*, 192 Ariz. at 205.

Based on the *Wayfair* decision, the State of Arizona established economic thresholds of gross income and gross proceeds of sales derived *under the retail TPT classification*, prior to any exemptions or deductions therefrom, for businesses without a physical presence in the State to be subject to TPT. See A.R.S. § 42-5044, *et. seq.*⁷

Economic nexus and the thresholds established by the State only apply to sales under the retail classification; thus, gross income and gross proceeds of sales derived by an out-of-state business under other classifications, such as personal property rentals, do not go toward establishing economic nexus and the established thresholds.

Use Tax:

If a company does not have an Arizona business presence or substantial nexus by physical presence or economic nexus for TPT purposes, Arizona's use tax may apply. Use tax applies to purchases from an out-of-state retailer, or utility business. A.R.S. § 42-5155(A) imposes Arizona's use tax on purchases of tangible personal property that are used, stored, or consumed in Arizona. The consumer is liable for the use tax; nevertheless, a vendor may be responsible for collecting and remitting the use tax to the state when the vendor assumes such collection and remittance responsibilities. A.R.S. § 42-5159 provides specific exemptions from the use tax for certain purchases of tangible personal property, including tangible personal property sold in Arizona already subject to TPT. See A.R.S. § 42-5159(A)(1).

Use tax is now less relevant due to the economic nexus laws established by Arizona that imposes TPT on out-of-state vendors based on sales to Arizona customers over a certain threshold. See below for further discussion on TPT versus use tax collection.

City Privilege Tax:

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 § -

⁷ For remote sellers, the thresholds for gross proceeds of sales or gross income derived from sales to Arizona customers under the retail TPT classification not facilitated by a marketplace facilitator are as follows: for calendar year 2019, \$200,000; for calendar year 2020, \$150,000; for calendar year 2021, \$100,000. A.R.S. § 42-5044(A)(1). For marketplace facilitators, the threshold for gross proceeds of sales or gross income derived from sales to Arizona customers under the retail TPT classification is more than \$100,000. *Id.* at § 42-5044(A)(2).

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 tax⁸.

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.

Sourcing:

If substantial nexus by physical presence exists and TPT applies, a business is then subject to TPT under all classifications and may rely on Arizona's "sourcing" rules to determine the appropriate tax rate for each applicable classification. Sourcing rules for each classification are provided in A.R.S. §§ 42-5034, -5040. *Arizona Transaction Privilege Tax Ruling TPR 20-2*⁹ provides further guidance regarding the retail and personal property leasing or rental sourcing provisions¹⁰.

Ruling:

An out-of-state company must have a substantial nexus with Arizona in order for Arizona to impose either TPT or the duty to collect use tax on the business. Substantial nexus exists when an out-of-state business has either substantial nexus by physical presence (applicable to all classifications) or economic nexus (applicable to the retail TPT classification) with the State. If a business establishes substantial nexus by physical presence with Arizona, then such business is subject to TPT for all business activities under all TPT classifications performed within the state or with Arizona customers. Businesses with only economic nexus, and no substantial nexus by physical presence, is subject to TPT under the retail classification.

Substantial nexus by physical presence:

An out-of-state business establishes substantial nexus by physical presence with Arizona by non-transitory activities performed within the State on the business' behalf—whether performed by the business's employees, agents, representatives, contractors, or affiliated persons—that are significantly associated with the business' ability to establish and maintain a market in this State

⁸ The MCTC can be found online at <https://azdor.gov/model-city-tax-code/model-city-tax-code>.

⁹ TPR 20-2 is available on the Department's website at <https://azdor.gov/legal-research/rulings/tpr-20-2>.

¹⁰ Tax rate tables can also be accessed at <https://azdor.gov/transaction-privilege-tax/tax-rate-table>.

for its sales. See *Ariz. Dep't of Revenue v. O'Connor, Cavanagh, Anderson, Killingsworth & Beshears, P.A.*, 192 Ariz. at 205 (citing *Tyler Pipe Industries*, 483 U.S. at 250); see also A.A.C. R15-5-2002(B).

Economic Nexus:

If an out-of-state business does not have substantial nexus by physical presence with Arizona, it must then be determined if they have economic nexus with the State. Remote sellers¹¹ (when not selling through a marketplace facilitator), and marketplace facilitators¹² (for sales on its own behalf and on behalf of at least one marketplace seller¹³) have economic nexus with Arizona if their annual gross proceeds of retail sales or gross income derived from retail sales to customers in the State, prior to any statutory deductions therefrom, are more than the thresholds set out in A.R.S. §§ 42-5044(A)(1)(a)-(c), (2)¹⁴. If only economic nexus exists, without physical presence, a business is then subject to TPT under only the retail classification. *Id.*

Only sales from the retail classification, prior to any statutory deductions therefrom, go towards the economic nexus thresholds; income derived from other classifications, such as the personal property rental classification, does not go toward such thresholds.

TPT vs. Use Tax Collection.

Due to the enactment of A.R.S. § 42-5044 and the provisions therein regarding economic nexus, the determination of whether Arizona will apply use tax or TPT, and thus which nexus requirement applies, is now less relevant. However, situations still exist where the determination may be applicable. Arizona takes the position that a higher level of nexus is not required to impose TPT over use tax and will generally impose TPT rather than use tax if a substantial nexus by physical presence exists¹⁵.

EXAMPLES:

These examples are provided in addition to those contained in A.A.C. R15-5-2002(D).

¹¹ Remote seller, as defined in A.R.S. § 42-5001(16)

¹² Marketplace facilitator, as defined in A.R.S. § 42-5001(9)

¹³ Marketplace seller, as defined in A.R.S. § 42-5001(10)

¹⁴ Under A.R.S. § 42-5044(A)(1)(c), (2), the threshold for the calendar year 2021 and for each calendar year thereafter is \$100,000 for both remote sellers and marketplace facilitators.

¹⁵ See *Care Computer Sys., Inc.*, 197 Ariz. at 416 (rejecting the argument that “a retail transaction privilege tax requires a higher level of nexus with the taxing state than does a use tax.”).

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.
3. The same out-of-state company from Examples 1 and 2, above, had the same \$150,000 in gross income derived from retail sales to Arizona customers in 2021. However, \$60,000 of such income was from services provided in addition to its retail sales, exempt from the retail classification per A.R.S. § 42-5061(A)(2), leaving only \$90,000 in taxable gross income under the retail classification for the year. The company still would have economic nexus with Arizona because the income derived from its retail sales of \$150,000, prior to any statutory deductions therefrom, exceeds the economic nexus thresholds.
4. An out-of-state company sells items of tangible personal property online, both as a remote seller through its own website and as a marketplace seller through a marketplace facilitator, and ships them via a common carrier from its warehouse located in Oregon. In 2021, the company derived \$65,000 in gross income from sales to Arizona customers from its website, and \$140,000 in gross income from sales to Arizona customers through the marketplace facilitator. The company would not have economic nexus with Arizona because its sales through the marketplace facilitator do not count toward the economic nexus thresholds for the company, and the amounts it derived from direct retail sales through its own website do not exceed the economic nexus thresholds. Therefore, the out-of-state company is not required to pay TPT as a remote seller.
5. 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.

6. From its website, an online retailer located in Kansas sells its products to customers located throughout the U.S., including Arizona. The retailer enters into agreements with residents of Arizona in which the retailer pays commissions or fees for referrals to the retailer's website. These marketing agreements establish substantial nexus by physical presence with Arizona because such activities are performed on the retailer's behalf to establish and maintain a market in Arizona for its sales, and thus the retailer's sales to Arizona customers would be subject to TPT. Because the retailer has substantial nexus by physical presence with Arizona, its sales would be taxable from the first dollar derived from its retail sales to Arizona customers as there is no economic threshold for out-of-state companies with substantial nexus by physical presence with the State like there is when only economic nexus exists.
7. A company located in Texas is awarded a construction contract and constructs a new office building located in Arizona. The construction activity would create substantial nexus by physical presence with Arizona for the Texas company and the company's gross income from its business activities in Arizona would be subject to TPT under the prime contracting classification, whether the company's own employees come into the state to construct the project or whether the company hires Arizona subcontractors to complete the project. In either event (i.e., whether through its relationships with Arizona contractors or through itself) the Texas company is performing a taxable activity within the state of Arizona.
8. An Illinois software company has employees who work from home, including an employee who lives, and works from home, in Arizona. The company does not have an office located in Arizona, nor does it own or lease any real or tangible personal property in the State. Whether the company's remote employee located in Arizona creates substantial nexus by physical presence with the State will depend on their role with the company. If the remote employee in Arizona is only involved in bookkeeping or in a general business administration function that is not significantly associated with the business' ability to establish and maintain a market in this State for its sales, then the presence of such remote employee in Arizona, alone, would not establish substantial nexus by physical presence with the State. However, if the remote employee in Arizona is providing sales, marketing, customer service, or other functions related to establishing and maintaining a market in Arizona for the company's sales, then the presence of such remote employee in the State would establish substantial nexus by physical presence for the company.

9. A printing business in Florida performs job printing services for Arizona customers. The Florida printing business completes its sales over the phone and through the internet, and does not have substantial nexus by physical presence with Arizona. The Florida business' job printing sales to Arizona customers exceeded \$100,000 in 2021. However, the company would not have economic nexus with Arizona from its job printing sales because only income derived from the *retail classification*, and not the job printing classification, go towards the economic nexus thresholds.
10. The same Florida printing business from Example 9, above, but the business has a third-party broker located in Arizona who solicits sales from Arizona customers on their behalf. Because the Florida printing business has a third-party broker located in Arizona soliciting sales on their behalf, it then has substantial nexus by physical presence with the State and would be subject to TPT under the job printing classification on the first dollar derived from the business in Arizona after substantial nexus by physical presence was established.
11. A Tennessee-based transportation company contracts to provide a monthly shipment of tangible personal property between two locations within Arizona, and hires an unrelated independent contractor who uses their own vehicle to transport the goods in Arizona. Because the Tennessee transportation company, through its contractor, regularly transports goods from a location beginning in Arizona, it has substantial nexus by physical presence with the State and would be subject to TPT under the transporting classification.
12. A South Dakota-based company provides bus tours of cultural landmarks located in Arizona, business activity that constitutes amusement under A.R.S. § 42-5073. The company hires a New Mexico company to provide and drive the bus, and also hires a California-based company to provide tour guides for the bus tours. Because the bus tour amusement activity is conducted within Arizona, the South Dakota-based company would have substantial nexus by physical presence with the State and the gross income it derives from sales of its tours would be subject to TPT under the amusement classification. See A.R.S. §§ 42-5034(A)(11), -5073.

Signed: , 2024

Explanatory Notice

The purpose of a tax ruling is to provide interpretive guidance to the general public and to department personnel. A tax ruling is intended to encompass issues of law not adequately covered in statute, case law or administrative rules. A tax ruling is a position statement that provides interpretation, details or supplementary information concerning the application of the law. Relevant statute, case law or administrative rules, as well as a subsequent ruling, may modify or negate any or all of the provisions of any tax ruling. See GTP 96-1 for more detailed information regarding documents issued by the Department of Revenue.