



## Taxation of Digital Services in AZ

- Status Quo
- Other States?
- Vision

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## Bottom Line

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- AZ among a few states who don't define digital goods/services
  - AZ is one of the ONLY states using our definition of TPP who taxes without a legal mandate, rule or case law
  - Taxation of digital goods/services TPT is based on ADOR interpretation
- Massive taxpayer confusion and uncertainty
- Taxpayers concerned about back taxes and interest
- Legislative clarity required

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## Status Quo

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- Non-custom software sold at retail has long been taxable by regulation
- § 42-5071 covers personal property rental classifications and exemptions
  - No definition or classification for digital goods/services or leased/subscribed software
- § 42-5001(16): ‘Tangible personal property’ is “personal property which may be seen, weighed, measured, felt or touched or is in any other manner perceptible to the senses
  - Definition does not indubitably capture all digital goods/services or leased/subscribed software
- No binding court judgement making digital goods/services taxable under TPT
- Some taxpayers pay TPT while others do not for similarly situated circumstances
  - Individual taxpayer rulings
  - ADOR guidance: apply TPT on nearly all digital services (October 2015 Directors Decision )

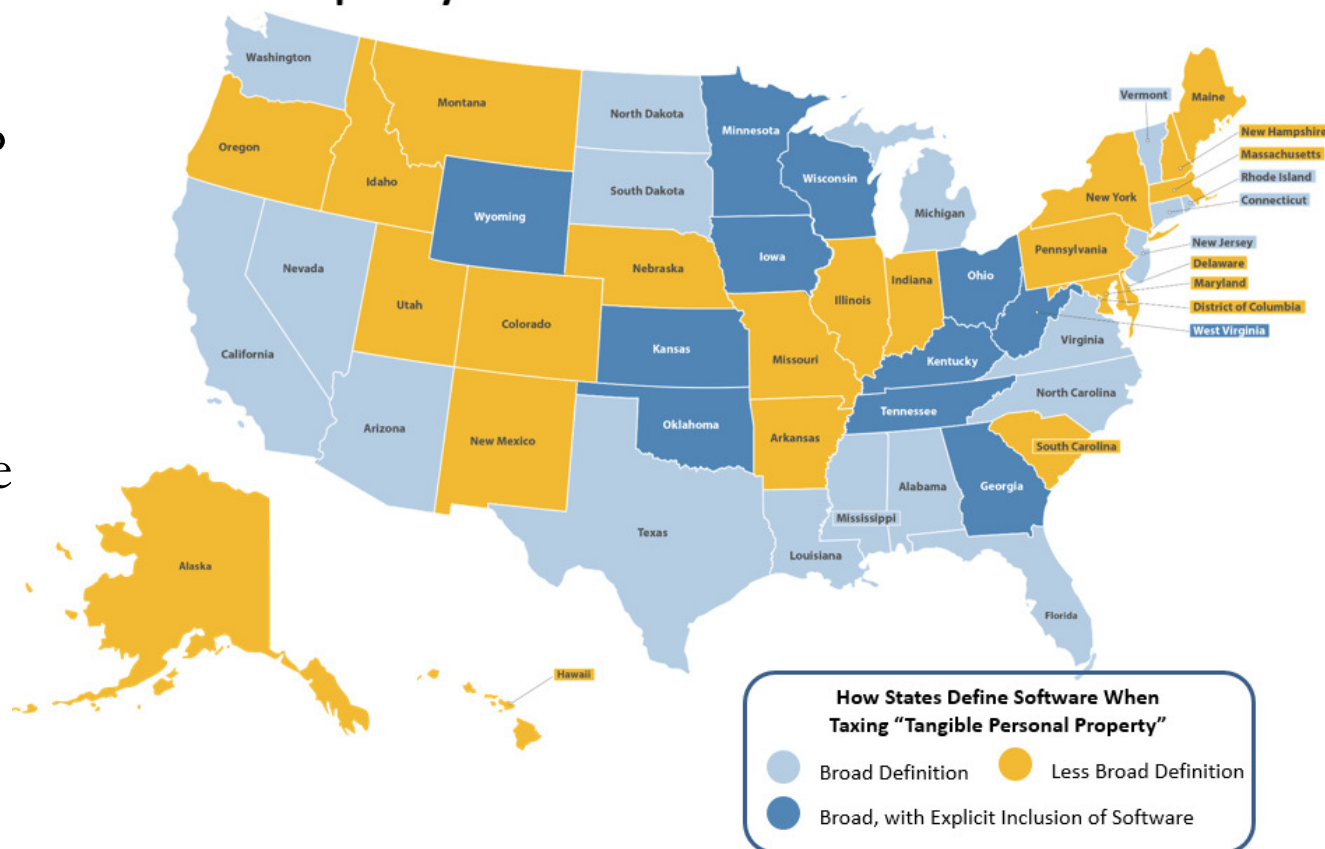
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  - Similar definitions of TPP
- Legal situations are very diverse across the 17
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## What are the 17 doing?

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  - Taxability of various digital goods/services flows from law change
  - Most have taxed perpetual & subscription software and exempted SaaS
  - South Dakota & Washington have taxed all digital services w/ law changes
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  - California, Florida, Virginia
- AZ, LA, & AL only states to tax of the group w/out law change
- LA & AL have administrative code/rule, AZ does not
- AZ only taxes SaaS without a law change (AZ has neither a law or rule)

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## Dept of Revenue Position

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- Digital services are taxable under the personal property rental classification
  - Anything digital is “tangible” because it can be viewed on media in some form
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  - Any service provided along with a taxable activity is also taxable (R15-5-1502)
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- Only exempt from TPT if software was uniquely created for customer (TPR 93-48)
  - “The provision of a canned computer program, whether or not characterized as a license agreement, is considered to be a taxable retail sale. Leases or rentals of this type of computer software are taxable under the personal property rental classification...” TPR 93-48

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## Exclusive Use & Control: “constructive possession”

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- *State Tax Commission v. Peck* (1970)
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  - All roads lead to: “Yes, that is taxable” unless it’s a customized product
  - Tax reporting agencies direct taxpayers to pay in nearly all circumstances
- **Tangible personal property:** any digital product or service, regardless of medium
- **Exclusive use:** Customer has unique access via login; content doesn’t need to be exclusive to the customer, simultaneous use is disregarded
- **Control:** Any manipulation ability of content establishes control; all business controls or inputs are described as irregular, minimal, troubleshooting, etc
- Legal position relies on linking the business models of coin-op laundries to digital services in *Peck* and insisting upon significant employee interfacing in tanning salons in *Energy Squared* in order to distance digital goods from that ruling

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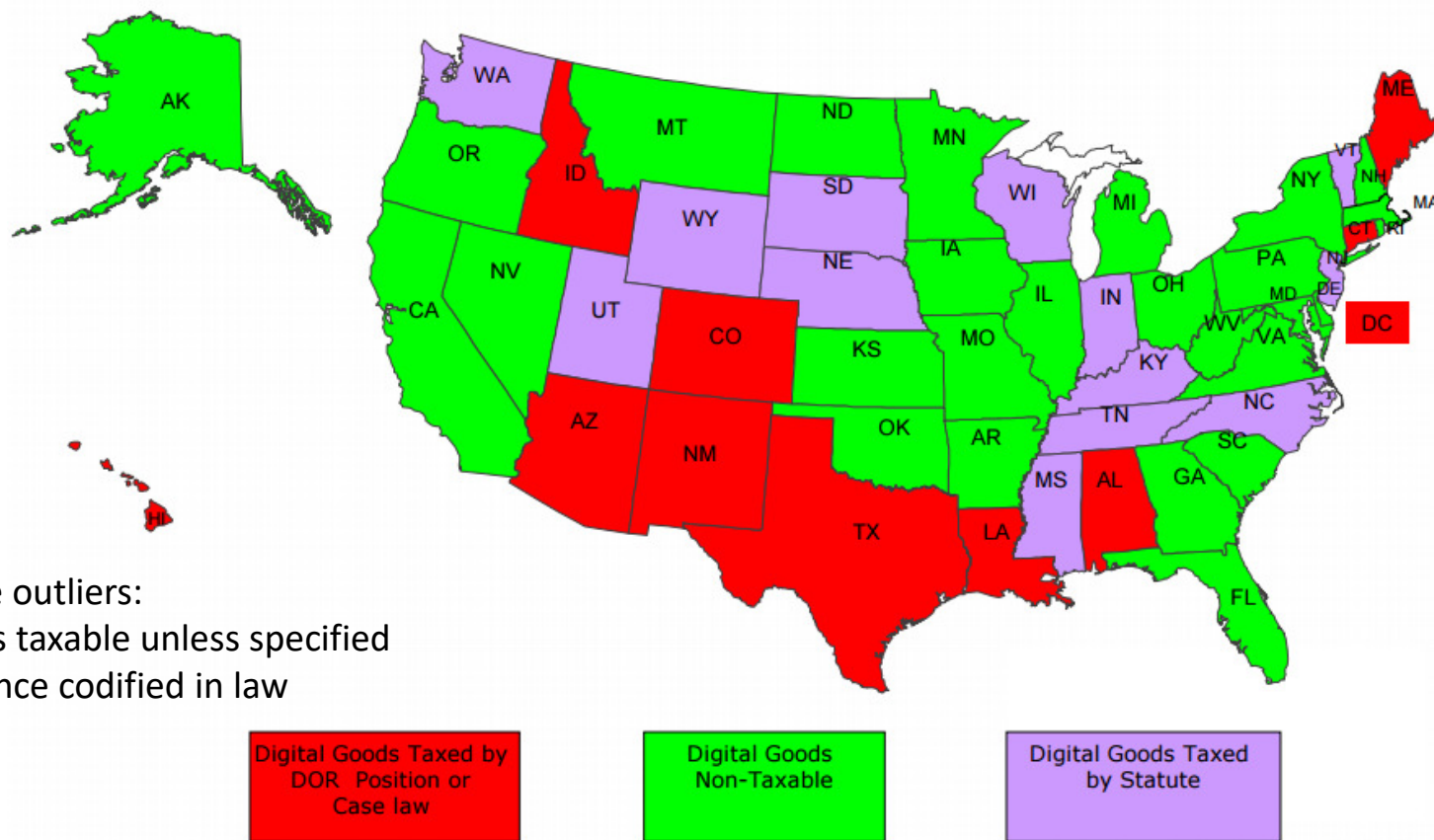
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Everything is taxable unless specified  
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## Example: Utah, Taxable by State Law

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- §59-12-103 Sales tax on purchaser on the purchase or sales price for:
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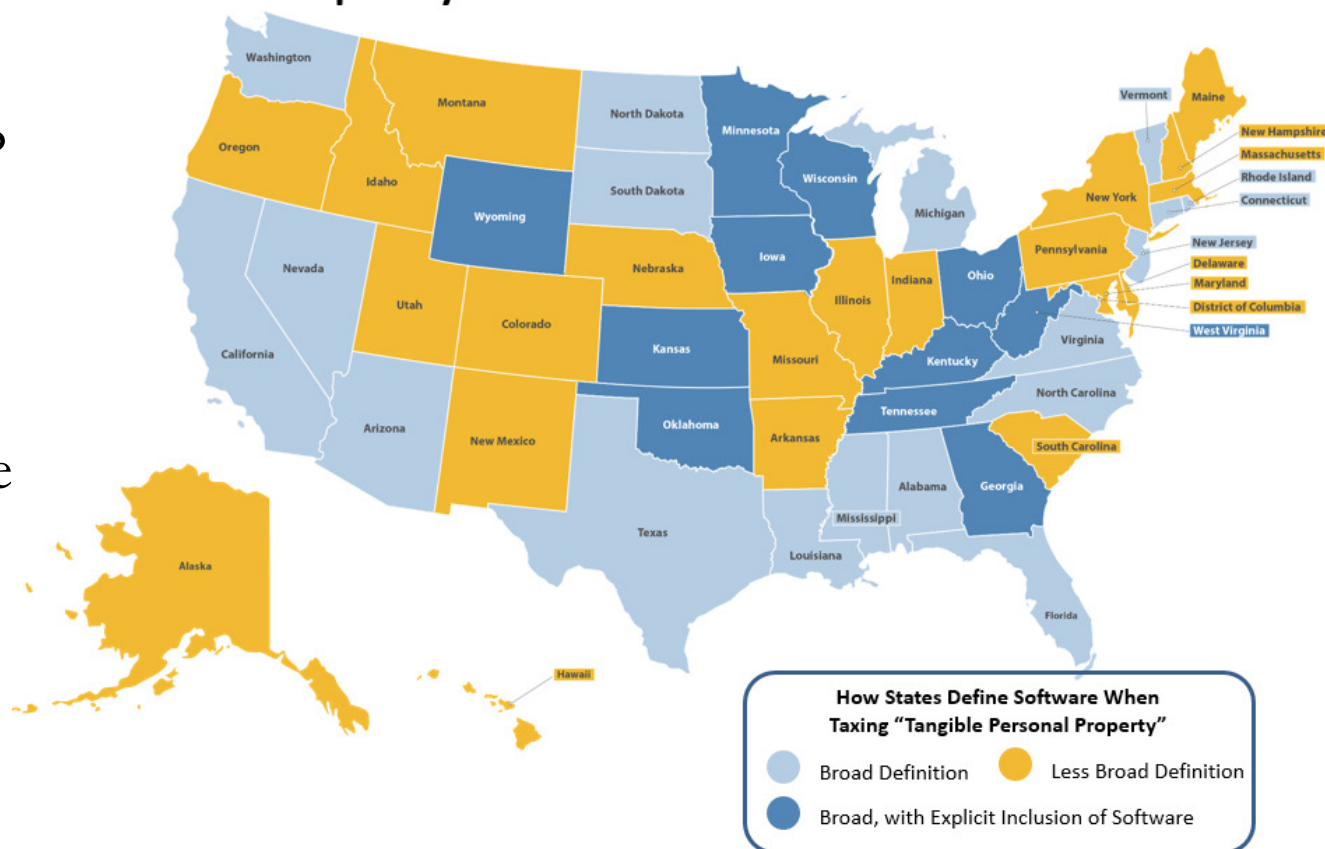




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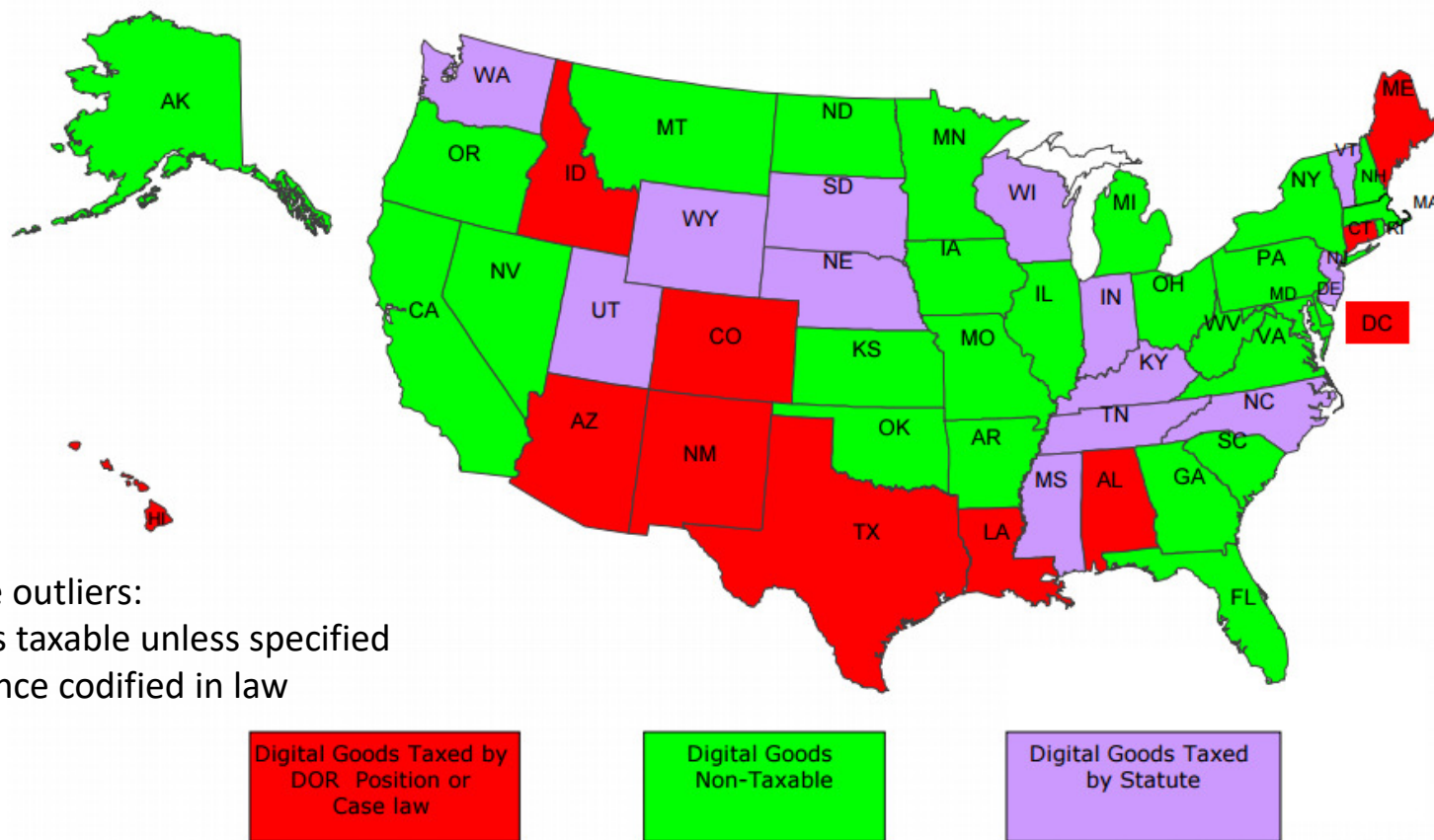
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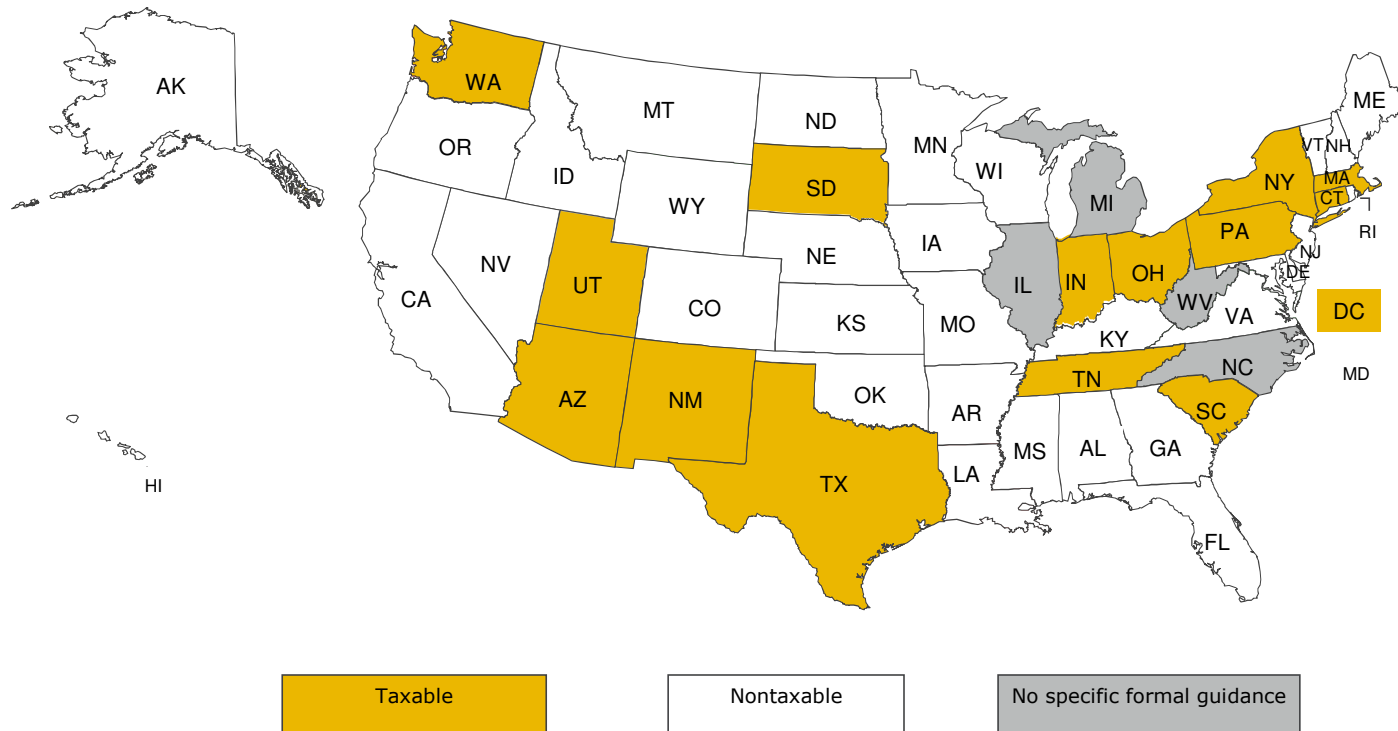
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## Taxation of Digital Services in AZ

- Status Quo
- Other States?
- Vision

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## Bottom Line

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- AZ among a few states who don't define digital goods/services
  - AZ is one of the ONLY states using our definition of TPP who taxes without a legal mandate, rule or case law
  - Taxation of digital goods/services TPT is based on ADOR interpretation
- Massive taxpayer confusion and uncertainty
- Taxpayers concerned about back taxes and interest
- Legislative clarity required

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## Status Quo

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- No explicit state law regarding TPT applying to digital goods and services
- Non-custom software sold at retail has long been taxable by regulation
- § 42-5071 covers personal property rental classifications and exemptions
  - No definition or classification for digital goods/services or leased/subscribed software
- § 42-5001(16): ‘Tangible personal property’ is “personal property which may be seen, weighed, measured, felt or touched or is in any other manner perceptible to the senses
  - Definition does not indubitably capture all digital goods/services or leased/subscribed software
- No binding court judgement making digital goods/services taxable under TPT
- Some taxpayers pay TPT while others do not for similarly situated circumstances
  - Individual taxpayer rulings
  - ADOR guidance: apply TPT on nearly all digital services (October 2015 Directors Decision )

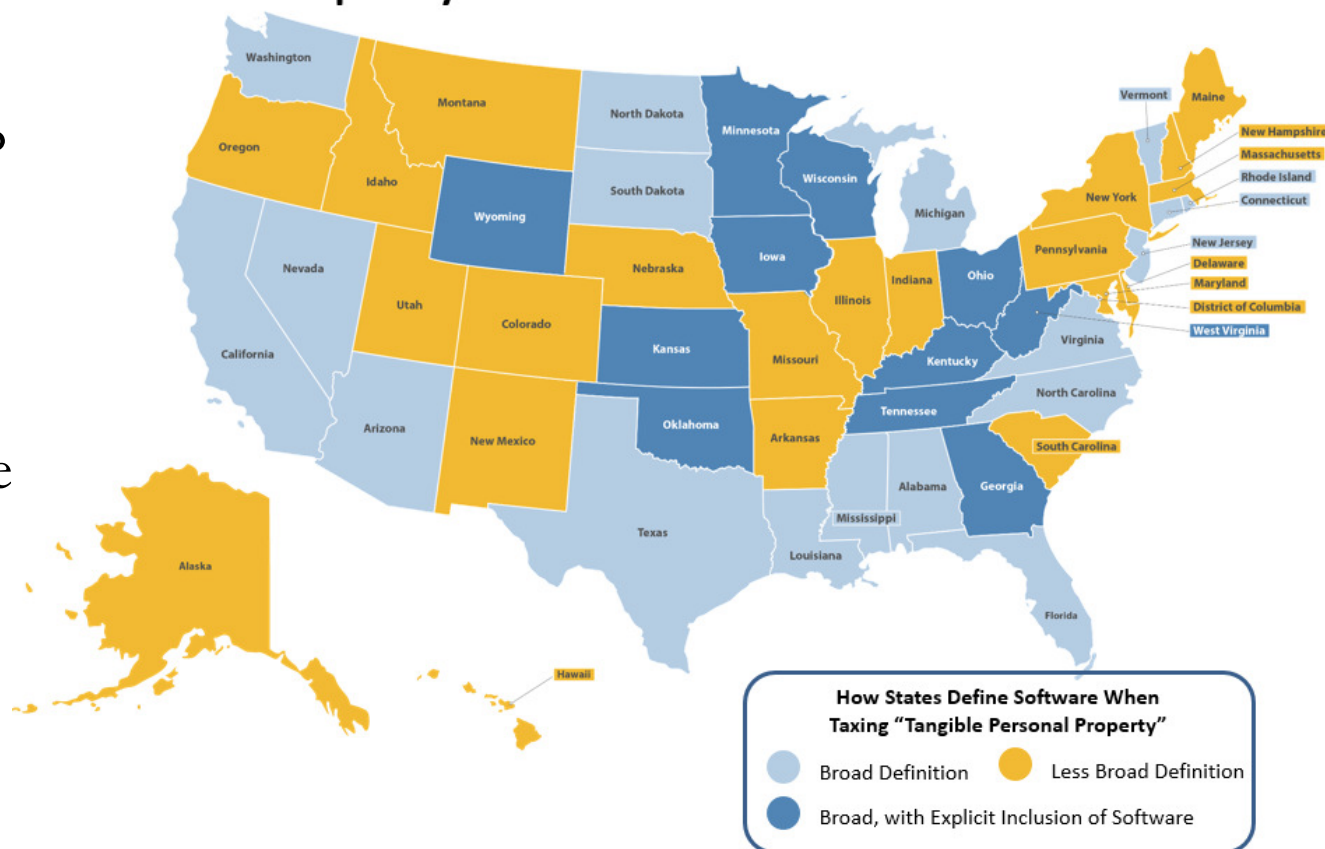
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## Is Arizona an Outlier?

- ADOR suggests
  - 17 states like AZ
  - Similar definitions of TPP
- Legal situations are very diverse across the 17
- Arizona has a rule for taxation of retail software sales (perpetual right)
- No other law or rule

**17 States have definition of TPP as broad as Arizona, and another 11 explicitly include software in its broad TPP definition**





## What are the 17 doing?

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- 11 have updated definition of TPP in state law to add software
  - Taxability of various digital goods/services flows from law change
  - Most have taxed perpetual & subscription software and exempted SaaS
  - South Dakota & Washington have taxed all digital services w/ law changes
- 3 without law changes have exempted all transactions
  - California, Florida, Virginia
- AZ, LA, & AL only states to tax of the group w/out law change
- LA & AL have administrative code/rule, AZ does not
- AZ only taxes SaaS without a law change (AZ has neither a law or rule)

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## Dept of Revenue Position

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- Digital services are taxable under the personal property rental classification
  - Anything digital is “tangible” because it can be viewed on media in some form
  - “Accessing” digital services is the same as renting/leasing tangible personal property
  - Any service provided along with a taxable activity is also taxable (R15-5-1502)
- Tax base is the gross proceeds until the contrary is established by taxpayer
- Only exempt from TPT if software was uniquely created for customer (TPR 93-48)
  - “The provision of a canned computer program, whether or not characterized as a license agreement, is considered to be a taxable retail sale. Leases or rentals of this type of computer software are taxable under the personal property rental classification...” TPR 93-48

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## Exclusive Use & Control: “constructive possession”

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- *State Tax Commission v. Peck* (1970)
  - AZ Supreme Court estab. rule of “exclusive use & control” for rental of tangible personal property
  - Coin-Op laundries were taxable because customer had exclusive use of machine, no personal services
- In *Energy Squared* (2002), Court of Appeals ruled tanning salons do not cede requisite control over devices, citing *Peck* and are not taxable under rental of personal property and are a service
- DOR:
  - Access to digital services is “exclusive” by virtue of a unique login & password
  - This “subscription” allows “exclusive” use of software content or digital platform, satisfying *Peck*
  - Actual possession of or a license granting “control” of software unnecessary to meet definition
  - “License to view” digital software provided online enough to satisfy “control” for leasing purposes
  - Ability to browse, search, extract, etc is enough to establish “control” = “constructive possession”
  - *Energy Squared* doesn’t apply to digital services because customers access it “without assistance”

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## ADORs Legal Interpretation

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- Each perspective of existing law maximizes taxation of digital goods and services
  - All roads lead to: “Yes, that is taxable” unless it’s a customized product
  - Tax reporting agencies direct taxpayers to pay in nearly all circumstances
- **Tangible personal property:** any digital product or service, regardless of medium
- **Exclusive use:** Customer has unique access via login; content doesn’t need to be exclusive to the customer, simultaneous use is disregarded
- **Control:** Any manipulation ability of content establishes control; all business controls or inputs are described as irregular, minimal, troubleshooting, etc
- Legal position relies on linking the business models of coin-op laundries to digital services in *Peck* and insisting upon significant employee interfacing in tanning salons in *Energy Squared* in order to distance digital goods from that ruling

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## ADORs Scope Widening

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- Digital services heretofore deemed untaxable are now taxable
- Effectively, nearly all digital services are now considered taxable
- March 2016 Directors Decision reversed earlier rulings
  - No law change or binding court ruling; ADOR relying on new analysis
  - Ruling: digital “cloud” storage now deemed taxable
  - ADOR doesn’t view the service as sufficiently customized/tailored to the customer
  - ADOR presumes digital services only require service when “customer has issues...”
  - Services provided are “minimal” and do not rise to standard set in *Energy Squared*
  - ADOR previously agreed customers did not have sufficient rights to control or possess software

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## 2016 TPR exempts electronic payment processing

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- In a reversal, TPR 16-011 declares gross receipts for electronic payment processing is not subject to TPT
- Web software interface is ‘tangible personal property,’ but
- ‘Exclusive control’ under *Peck* not established
  - Vendor is involved in transactions, requests payments, updates data etc
- Customer is not ‘renting’ software because charges are relative to dollar amount in transaction and not subscription based
  - New legal consideration not found in Arizona case law



## Shifting legal target “exclusive use & control”

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Both TPRs are for Cloud Computing Activity

2015

However, when customers browse, search, print and arrange Taxpayer's content, they control Taxpayer's software to manipulate the presentation of the content. At that point, the customers control the manual operation of their searches, and they generally perform their searches without requiring assistance or guidance from Taxpayer's personnel. Contrary to the tanning bed customer in *Energy Squared*, who “typically knows nothing about how to get what he wants using the taxpayer's equipment,”<sup>1</sup> Taxpayer's customers browse and search Taxpayer's database independently.

“Constructive Possession Philosophy”

2016

\*\*\*'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.

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 \*\*\*

“Exclusive Use & Control Philosophy”

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## Five Primary Legal Questions

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1. Is the digital service or good “tangible” personal property?
2. Does the renter or lessee have “exclusive use AND control”?
3. What are the gross proceeds of transaction?
4. How is nexus established for purposes of TPT remittance?
5. How is TPT sourced (which jurisdiction gets the tax?; All of it?)

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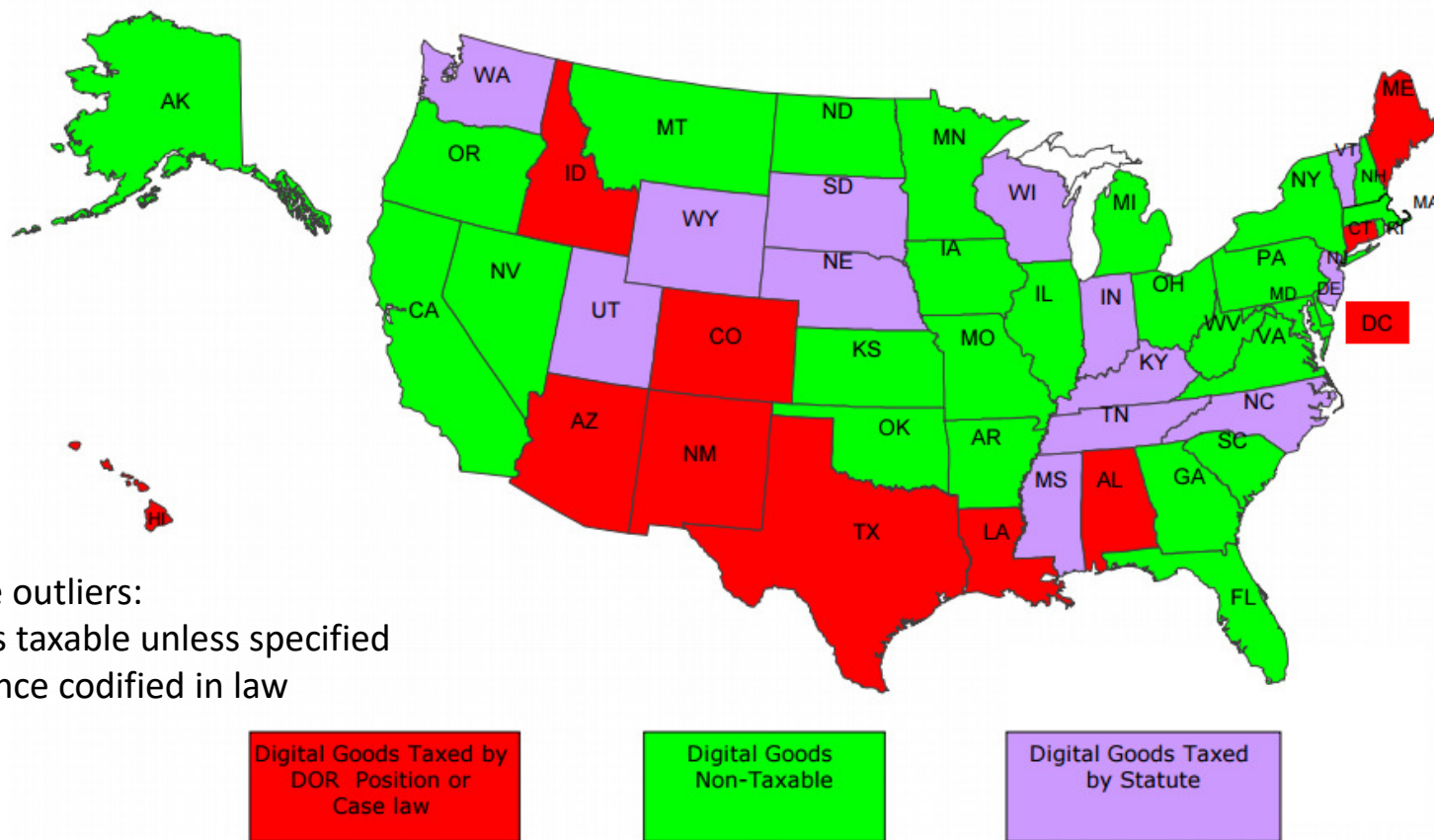
## What about other states?

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- 18 states like Arizona have not statutorily defined taxation of digital goods/services; most do not apply a tax
- 24 states have adopted streamlined sales tax (SSUTA) definitions
  - Can choose to tax or not to tax
  - SST encourages uniformity of definitions for taxpayer ease
- Many states have attempted to define and tax digital goods/services
- Some states have defined and exempted digital services only or both
- Several states tax digital services but exempt data processing like data entry, payroll services, inventory control



# Sales Tax on Sales of Digital Goods



NM & HI are outliers:  
Everything is taxable unless specified  
Idaho has since codified in law

Source: COST

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## Arizona Tax Research Association

State	Definition of TPP	Software - Perpetual (Delivered Electronically)	Software - Subscription (Delivered Electronically)	Software-as-a-Service (Hosted or ASP)	Other Digital Goods
Arizona	Ariz. Rev. Stat. § 42-5001 (17) "Tangible personal property" is property that can be seen, weighed, measured, felt or touched or is in any other manner perceptible to the senses." MCTC does not define TPP.	Taxable - Retail (Ariz. Admin. Code R15-5-154 canned software is TPP regardless of how delivered - this regulation applies to the retail classification only)	Taxable - TPP Rental (DOR Interpretation)	Taxable - TPP Rental (DOR Interpretation)	Taxable - Retail or Rental depending upon terms (DOR Interpretation)
California	Cal. Rev. and Tax Code § 6016 "Tangible personal property" means personal property which may be seen, weighed, measured, felt, or touched, or which is in any other manner perceptible to the senses.	Exempt (BOE interpretation)	Exempt (BOE interpretation)	Exempt (BOE interpretation)	Exempt (BOE interpretation)
Nevada	Nev. Rev. Stat. § 372.085 "Tangible personal property" means personal property which may be seen, weighed, measured, felt or touched, or which is in any other manner perceptible to the senses. Nev. Rev. Stat. § 360B.485 "Tangible personal property" includes, but is not limited to, electricity, water, gas, steam and prewritten computer software. The term <b>does not include any products that are transferred electronically to a purchaser.</b>	Exempt (Nev. Rev. Stat. § 360B.485)	Exempt (Nev. Rev. Stat. § 360B.485)	Exempt (Nev. Rev. Stat. § 360B.485)	Exempt (Nev. Rev. Stat. § 360B.485)
Texas	Tex. Codes 151.009 "Tangible personal property" means personal property that can be seen, weighed, measured, felt, or touched or that is perceptible to the senses in any other manner, and, for the purposes of this chapter, <b>the term includes a computer program</b> and a telephone prepaid calling card. Tex. Codes 151.010 "Taxable item" means tangible personal property and taxable services. Except as otherwise provided by this chapter, <b>the sale or use of a taxable item in electronic form instead of on physical media does not alter the item's tax status.</b>	Taxable (Tex. Codes 151.009)	Taxable (Tex. Codes 151.009)	Not taxed as TPP 20% exemption as data processing services (Comptroller interpretation of Tax Code Ann. Section 151.0101(a)(12))	Taxable (Tex. Codes 151.010)



## Example: Utah, Taxable by State Law

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- §59-12-103 Sales tax on purchaser on the purchase or sales price for:
- (M) amounts paid or charged for a sale:
  - (i)(A) of a product transferred electronically; or
  - (B) of a repair or renovation of a product transferred electronically; and
- (ii) regardless of whether the sale provides:
  - (A) a right of permanent use of the product; or
  - (B) a right to use the product that is less than a permanent use, including a right:
    - (I) for a definite or specified length of time; and
    - (II) that terminates upon the occurrence of a condition
- Gross proceeds: All costs including services whether sold, used, consumed or leased
- Non-nexus Sellers not required to collect; buyers should pay use tax
- Sourcing: location the customer receives goods/services at 1<sup>st</sup> payment

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# Critical Taxpayer Issue Reaching Boiling Point

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- Most states have attempted to address the issue in state law
  - No one state is deemed as a model; no silver bullet strategy
  - Difficult to define; digital services are a moving target
  - Arizona has made no attempt
- Tax analysts are telling companies AZ taxes all digital goods/services
  - Though there is no legal basis, ADORs private letters influence
  - Companies one by one being told they owe back taxes
- Massive taxpayer confusion
- AZ cannot possibly be a leader in IT under present circumstances

From taxjar.com

For example, some states consider SaaS a service. So if services are generally taxable in the state – such as in Arizona – then SaaS is considered taxable. In most states, where services aren't taxable, SaaS also isn't taxable. Other states, like



## Guiding Legal Principles

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- Due Process
  - AZ Court of Appeals rejected a city's attempt to impose taxes because the tax laws' "existence must at least be made reasonably knowable." *APS v San Luis*, 2017
- Tax compliance; AZ Supreme Court has stressed:
  - “the duty imposed by [a statute] must be prescribed in terms definite enough to serve as a guide to those who have the duty imposed upon them,” and “it must be definite and certain enough to enable every person, by reading the law, to know what his rights and obligations are and how the law will operate when put into execution.” *Duhamel v. State Tax Comm’n*, 1947
  - “it is especially important in tax cases to begin with the words of the operative statute,” and “such words will be read to gain their fair meaning, but not to gather new objects of taxation by strained construction or implication.” *State Tax Comm’n v. Staggs Realty Corp.*, 1959

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## Charge to Lawmakers

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- Provide clarity in law to fullest extent possible
- Tax the activity you think is taxable, exclude the remaining
  - Do not leave the decisions to administrators
  - Use precise language; don't leave room for language straining
- Make the difficult policy choices now
  - Difficulty level compounds with time as digital grows
  - Inaction leaves the state legally liable
  - Inaction leaves taxpayers in a precarious position

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# ARIZONA TAX RESEARCH ASSOCIATION

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## Questions?

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