

NOTICE OF FINAL RULEMAKING

TITLE 15. REVENUE

CHAPTER 5. DEPARTMENT OF REVENUE

TRANSACTION PRIVILEGE AND USE TAX SECTION

PREAMBLE

- | <u>1.</u> | <u>Sections Affected</u> | <u>Rulemaking Action</u> |
|------------------|---------------------------------|---------------------------------|
| | R15-5-150 | Amend |
| | Article 11 | Amend |
| | R15-5-1101 | New Section |
| | R15-5-1102 | New Section |
| | R15-5-1103 | Repeal |
| | R15-5-1104 | Repeal |
| | R15-5-1105 | Repeal |
| | R15-5-1106 | Amend |
| | R15-5-1107 | Repeal |
| | R15-5-1109 | Repeal |
| | R15-5-1111 | Amend |
| | R15-5-1112 | Amend |
- 2.** **The specific statutory authority for the rulemaking, including both the authorizing statute (general) and the implementing statutes (specific):**
- Authorizing statute: A.R.S. § 42-1005
- Implementing statutes: A.R.S. §§ 42-5061, 42-5066
- 3.** **The effective date of the rules:**

The effective date is 60 days after the date the final rules are filed with the Office of the Secretary of State.

4. A list of all previous notices appearing in the *Register* addressing the final rules:

Notice of Rulemaking Docket Opening: 9 A.A.R. 3892, September 5, 2003

Notice of Rulemaking Docket Opening: 9 A.A.R. 5154, November 28, 2003

Notice of Proposed Rulemaking: 10 A.A.R. 766, March 5, 2004

Notice of Supplemental Proposed Rulemaking: 10 A.A.R. 3554, September 3, 2004

Notice of Oral Proceeding on Proposed Rulemaking: 10 A.A.R. 4208, October 15, 2004

5. The name and address of agency personnel with whom persons may communicate regarding the rulemaking:

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Please visit the Department's Web site to track the progress of these rules and other agency rulemaking matters at www.azdor.gov/tra/draftdoc.htm.

6. An explanation of the rules, including the agency's reasons for initiating the rulemaking:

This rulemaking clarifies the Department's positions regarding the imposition of Arizona transaction privilege tax on businesses that: (1) are subject to tax under the retail and job printing classifications and (2) engage in sales of various forms of printing and photography. The amendments provide taxpayers with greater delineation of the scope of business activities subject to tax under the respective classifications, including definitions for the terms “image developing,” “job printing,” and “photography,” and explain the application of related exemptions found in A.R.S. §§ 42-5061 and 42-5066.

7. A reference to any study relevant to the rules that the agency reviewed and either relied on or did not rely on in its evaluation of or justification for the rules, where the public may obtain or review each study, all data underlying each study, and any analysis of each study and other supporting material:

None

8. A showing of good cause why the rules are necessary to promote a statewide interest if the rules will diminish a previous grant of authority of a political subdivision of this state:

Not applicable

9. A summary of the economic, small business, and consumer impact:

There should be no significant economic impact resulting from adoption of the rules. The business activities that fall within the scope of this rulemaking are all currently subject to transaction privilege tax under either the retail or job printing classification, both of which have the same state tax rate. The rulemaking does, however, provide the public with greater guidance on the parameters of these classifications as they apply to the activities. Because the amendments clarify and more accurately explain the scope

and nature of the imposition of or exemptions from transaction privilege tax for sales of photography and printing, a minimal impact may occur for certain vendors due to increased compliance measures. The Department expects that the benefits of the amended rules to the public and the agency from achieving a better understanding of the exemptions will be greater than the costs.

10. A description of the changes between the proposed rules, including supplemental notices, and final rules:

The following subsections describe the changes from the supplemental proposed rules that appear in the final rules *infra*:

- a. In response to a comment received by the Department (see Paragraph 11(k) *infra*), in the definitions found in A.A.C. R15-5-150(A)(3), R15-5-1101(1), and R15-5-1101(3), the Department has replaced use of the term “digital or analog storage medium” with “data storage medium.” The Department concluded that using the term “data storage medium” would clarify the rules without altering the scope of media types covered by the definition. The change is consequently not substantial in nature.
- b. The Department added references in A.A.C. R15-5-150(A) to the statutory definitions for "motion picture" and "motion picture production company" that govern the motion picture production tax incentives enacted by Laws 2005, ch. 317, and also added a definition for "qualified motion picture production company" to reference those taxpayers entitled to transaction privilege and use tax exemptions under the new legislation. Language has also been added in A.A.C. R15-5-150(C) of the final rules to address the new exemptions. Because the

clarification does not modify or change any general principles of the rules regarding sales of photography as previously proposed in the September 3, 2004 Notice of Supplemental Proposed Rulemaking, but rather, merely references a new retail classification exemption enacted during the course of the rulemaking, the change is not substantial in nature.

- c. In response to a comment received by the Department (see Paragraph 11(d) *infra*) on a grammatical error found in A.A.C. R15-5-150(B), the Department has amended the first sentence of the provision to read "*derived from* a sale" instead of "*of* a sale" (emphasis added). This change is not substantial in nature.
- d. In response to a comment received by the Department (see Paragraph 11(j) *infra*) requesting the inclusion of a reference to "location scouting fees" to the second sentence of A.A.C. R15-5-150(B), the Department has amended the provision. Additionally, in response to a question by the Governor's Regulatory Review Council staff, the reference to "location changes" [*sic*, location charges] has been removed. The reference was intended by the Department to refer to fees that are more specifically and clearly addressed by the "location scouting fees" reference. As the clarifications do not modify an interpretation under the rules as previously proposed in the September 3, 2004 Notice of Supplemental Proposed Rulemaking, the change is not substantial in nature.
- e. In response to a suggestion by the Governor's Regulatory Review Council staff, A.A.C. R15-5-150(B) has been clarified to better incorporate the application of the A.A.C. R15-5-104(C) "inconsequentiality test" to sales of photography. As the clarification does not modify an interpretation under the rules as previously

proposed in the September 3, 2004 Notice of Supplemental Proposed Rulemaking, the change is not substantial in nature.

- f. In response to a comment received by the Department (see Paragraph 11(c) *infra*) regarding A.A.C. R15-5-150(C), the Department has removed the language that was provided in A.A.C. R15-5-150(C) in the September 3, 2004 Notice of Supplemental Proposed Rulemaking. The clarification is not substantial in nature.
- g. In response to a comment received by the Department (see Paragraph 11(g) *infra*), the Department has amended the third sentence of A.A.C. R15-5-1101(B) by deleting "digital printing" as an example of a job printing activity due to confusion and ambiguity caused by the term. The deletion of the term is minor, as the examples provided in the rule are merely illustrative in nature. As such, the change is not substantial in nature.
- h. In response to a suggestion by the Governor's Regulatory Review Council staff, the Department has conformed references to a printer's shipments or deliveries outside the state for use outside the state, which are exempt under A.R.S. § 42-5066(B)(2). The Department has also deleted references to "interstate or foreign commerce" as redundant and unnecessary wording. The changes are not substantial in nature.
- i. In response to a comment received by the Department (see Paragraph 11(h) *infra*), the Department expounded upon the general provisions of A.A.C. R15-5-1102 by adding a subsection (E) to address a specific question regarding the tax treatment of printing that is delivered to a location outside of Arizona. Because the new subsection merely provides further exposition on language that was already

contained in the Notice of Supplemental Proposed Rulemaking, the change is not substantial in nature.

- j. In response to a comment received by the Department (see Paragraph 11(i) *infra*) requesting a reference to retail classification exemptions that potentially apply to sales of materials to job printers, the Department has amended A.A.C. R15-5-1106 to include a reference to A.R.S. § 42-5061. As the clarification does not modify any interpretation under the rules as previously proposed in the September 3, 2004 Notice of Supplemental Proposed Rulemaking, the change is not substantial in nature.
- k. In response to a comment received by the Department (see Paragraph 11(e) *infra*) addressing situations in which sales of photography would be considered inconsequential elements of nontaxable activities, A.A.C. R15-5-150(B) has been amended to clarify the application of A.R.S. §§ 42-5061(A)(1) and (A)(2) to such scenarios. The change incorporates the Department's established interpretations of these statutory exemptions, as detailed in Paragraph 11(e), and is thus not substantial in nature.
- l. In response to a comment received by the Department after the close of the official comment period (see Paragraph 11(n) *infra*) regarding the examples provided under A.A.C. R15-5-1101(2), the third sentence of the rule has been amended to clarify that the list provides examples of *methods* of job printing. The change is not substantial in nature.
- m. The Department has made minor stylistic and grammar-related changes suggested by the Governor's Regulatory Review Council staff.

11. A summary of the comments made regarding the rules and the agency response to them:

The following subsections provide summaries of comments made regarding the Notice of Supplemental Proposed Rulemaking and the Department's responses to each comment:

- a. *Comment:* Two industry associations submitted written comments and a tax practitioner submitted an oral comment disagreeing with the Department's decision to address electronic-based printing and distribution of printing in the A.A.C. Title 15, Article 11 job printing classification rules. The commenters questioned whether the scope of the job printing classification encompasses transactions involving digital forms of tangible personal property. Another tax practitioner submitted a related oral comment questioning the inclusion of digital forms of photographic images in A.A.C. R15-5-150, as it concerns sales of photography.

Response: The Department responded to this concern in the Notice of Supplemental Proposed Rulemaking, noting that during the April 5, 2004 oral proceeding held for the proposed rules, several attendees raised concerns about the Department's use of medium- and technology-neutral terminology in explaining the application of Arizona transaction privilege tax. Equal treatment of traditional and electronic forms of tangible personal property, reflected in the prior and present versions of the rules, is imperative to achieving parity in taxation. The Department's rules discussing taxable job printing activities that result in digital forms of printing are consistent with the Department's treatment of sales of electronic property as tangible personal property. A.R.S. § 42-5001(16)

broadly defines "[t]angible personal property" as "personal property which may be seen, weighed, measured, felt or touched or is in any other manner perceptible to the senses." This definition has existed in nearly identically worded form since the compilation of excise tax statutes in this state. *See* Ariz. Code § 73-1302 (1939); Laws 1935, ch. 77, art. II, § 1. The Department's longstanding position is that gross receipts derived from sales and leases of all forms of tangible personal property are taxable unless otherwise exempt. *See* State v. Jones, 137 P.2d 970 (Ariz. 1943) (sales of music emanating from taxpayer's jukeboxes constitute taxable sales of tangible personal property); A.A.C. R15-5-1853(C) (Supp. 87-2) (gross receipts derived from sale of non-custom electronic data processing programs are taxable as retail sales of tangible personal property); Ariz. Tax Ruling No. 1-17-83 (June 1, 1983) ("[m]ass-produced or standard software available to any purchaser" are subject to tax as "tangible personal property as music tapes and records, books and computer games"); Ariz. Transaction Privilege Tax Ruling TPR 93-48 (taxation of computer hardware, software, and related services); *see also* Ariz. Private Taxpayer Ruling LR04-010 (Nov. 15, 2004); Ariz. Private Taxpayer Ruling LR04-007 (Aug. 31, 2004); Ariz. Private Taxpayer Ruling LR02-020 (Nov. 5, 2002); Ariz. Private Taxpayer Ruling LR95-010 (Oct. 12, 1995).

A separate but related issue raised by this comment involves delineating the scope of the job printing classification to include electronic-based copying and reproduction activities. A general maxim for tax statutes is that they be given strict construction against the taxing authority and resolved in favor of the

taxpayer. *See, e.g., State ex rel. Ariz. Dep't of Revenue v. Capitol Castings, Inc.*, 88 P.3d 159, 161 (Ariz. 2004); *Energy Squared, Inc. v. Ariz. Dep't of Revenue*, 56 P.3d 686, 689 (Ariz. Ct. App. 2002). Nevertheless, the approach is a default position used when ambiguity or uncertainty exists in the statute. *See Energy Squared, id.* More specifically, it is ambiguity that continues to be present after completing the normal process of statutory construction, which involves first looking to the words of the statute itself and according the statute its “plain meaning” if clear. *See, e.g., Centric-Jones v. Town of Marana*, 937 P.2d 654, 658 (Ariz. Ct. App. 1996). If there is any ambiguity, the rules of statutory construction then require the statute to be construed *as a whole*, considering its context, language, subject matter, historical background, effect and consequences, and spirit and purpose. *See State Tax Comm'n v. Wallapai Brick & Clay Prods.*, 330 P.2d 988, 992-93 (Ariz. 1958); *Centric-Jones, id.*; *State ex rel. Ariz. Dep't of Revenue v. Phoenix Lodge No. 708, Loyal Order of Moose, Inc.*, 928 P.2d 666, 671 (Ariz. Ct. App. 1996). That ambiguities are interpreted in favor of the taxpayer does not mean that courts should give words of a statute a “constricted or unnatural meaning” to support such an interpretation; instead, the language must be given its “full” or “plain and ordinary” meaning. *See Loyal Order of Moose, id.*; *Wilderness World, Inc. v. Ariz. Dep't of Revenue*, 895 P.2d 108 (Ariz. 1995). When interpreting a tax statute, courts follow the doctrine of *ejusdem generis*, which requires that an activity being taxed be substantially of the same kind, class, or character as those activities specifically enumerated in the statute. *See*

Wilderness World Inc. v. Ariz. Dep't of Revenue, 882 P.2d 1281 (Ariz. Ct. App. 1993) (reversed in part on other grounds).

In clarifying specific applications of the statute in the administrative rules, the Department has had no need to strain the terms used in A.R.S. § 42-5066 to make taxable those activities that would otherwise be nontaxable. Instead, the Department has clarified the parameters of the job printing classification for taxpayers by discussing the application of transaction privilege tax to activities that are of the same nature and character as those already discussed in statute and current regulation, and by distinguishing what business activities and services are nontaxable. A.R.S. § 42-5066 states that the job printing classification includes "copying." The plain and ordinary meaning of the term "copying," as used in the statute, is intrinsically broad, and the final amended rules merely clarify that copying is taxable regardless of whether the copies of documents or data generated are physical "hard" copies or electronic. The Department has avoided merging into the "copying" concept of the job printing classification those activities that only tangentially involve or do not involve copying activities *by printers*, in keeping with the intent and purpose of the classification to tax the activities of those engaged in the business of "job printing, engraving, embossing, and copying."

- b. *Comment:* The Department received an oral comment from a tax practitioner asking about the transaction privilege tax treatment of fees paid to the owner of a photograph that transfers a copy of the image to another for a particular use (*e.g.*,

reproduction in a magazine), in a manner that does not constitute an outright retail sale.

Response: From a technical standpoint, this question may involve the personal property rental classification found at A.R.S. § 42-5071, depending on the contractual arrangement between the owner and user, and as such would be beyond the scope of the immediate rulemaking, which affects only the retail and job printing classifications. Nevertheless, the comment concerns a related aspect involving photography that warrants a brief explanation in this notice. Just as sales of photography can involve photographic images that are conveyed in various forms yet still constitute sales of tangible personal property subject to transaction privilege tax under the retail classification, leases and rentals of photography are subject to tax under the personal property rental classification. For such leases and rentals, A.R.S. § 42-5071(A)(7) provides an exemption for those images "used by this state on internet web sites, in magazines or in other publications that encourage tourism." Nevertheless, leases and rentals of images are distinguished from amounts derived by holders of copyright interests *solely* from transfers and assignments of such rights (*e.g.*, through a technology transfer agreement), if the latter transactions do not implicate any transfers of tangible personal property for consideration and otherwise fall outside the scope of activities subject to transaction privilege tax. Again, the parameters of what constitutes a taxable lease or rental of tangible personal property rather than a nontaxable transfer and assignment of intangible rights over such property depends on the particular terms of a contract and would not be unique to the area

of photography as opposed to any other form of tangible personal property. Consequently, the Department does not perceive a need to amend A.A.C. R15-5-150 at this time.

- c. *Comment:* The Department received an oral comments before and after the close of the official comment period from a tax practitioner who questioned whether the sale of photography to a person who incorporates the photography into a publication would qualify as an exempt sale for resale, suggesting that A.A.C. R15-5-150(C) as proposed in the September 3, 2004 Notice of Supplemental Proposed Rulemaking should be amended to address the issue. The tax practitioner raised a hypothetical in which an advertising agency hires a third-party "representative" to provide a photographic image, whereupon the representative hires a photographer to actually take and supply the image. The photographer sells the image to the representative for a fee, and the representative then sells the image without further editing or manipulation to an advertising agency for the fee it paid plus a markup.

Response: The intent of A.A.C. R15-5-150(C) was limited, in that it was merely to reword the general exclusion of sales for resale from transaction privilege tax under the retail classification for purposes of photography. Nevertheless, upon reviewing the source of confusion caused by the rephrasing, as was evident from this comment, the Department found that an explanation was no longer necessary for clarification. The original explanation at A.A.C. R15-5-150(C) was intended to provide the treatment of sales for resale of developing and printing activities. These exempt sales, which this rulemaking now clarifies are sales subject to tax

under the *job printing* classification rather than the retail classification, are now fully addressed in A.A.C. R15-5-1112. As this particular issue involving developing and printing activities no longer applies in the area of retail sales of photography, there is no longer a need to specifically address sales for resale in this provision. The Department has thus removed the proposed amended language in A.A.C. R15-5-150(C) stating that "[g]ross income or gross proceeds of a sale of photography to a business that resells the supplied image as a retail sale of tangible personal property are not taxable" under the retail classification. This removal has also been noted in Paragraph 10(e) *supra*.

The Department does not perceive a present need to include additional language to address the scenario raised by the practitioner in the hypothetical. The facts do not suggest a situation that distinguishes the transactions from any other sale or transfer of tangible personal property, where gross receipts of a sale of tangible personal property for resale are not subject to tax under the retail classification because the transaction does not constitute "selling at retail." In the hypothetical, the sale of the image by the photographer to the representative would be a nontaxable sale for resale, while the gross receipts of the representative from the representative's subsequent sale to the advertising agency would be subject to tax.

- d. *Comment:* The Department received an oral comment from a tax practitioner who suggested that, in the first sentence of A.A.C. R15-5-150(B), "[g]ross income or gross proceeds derived *of* a sale" should instead read "[g]ross income or gross proceeds derived *from* a sale."

Response: The Department agrees with the suggestion and has amended the rules. A description of the change has been provided under Paragraph 10(c) *supra*.

- e. *Comment:* The Department received an oral comments from a tax practitioner before and after the close of the official comment period regarding the transaction privilege tax consequences for instances in which the A.A.C. R15-5-104(C) "inconsequential element" provision would not apply to a business engaging in sales of photography. The practitioner asked whether the Department contemplated that activities such as editing would constitute a service in addition to a sale because it would not be a part of the process of taking and supplying a customer with an image. The practitioner also questioned whether gross income derived from fees for the process of taking images should be included as part of a vendor's taxable gross receipts for the sale of photography.

Response: Before specifically addressing this comment, it is worth reiterating that Arizona transaction privilege tax is a tax on the privilege of conducting business in the state, and is measured by the *gross receipts* of the taxpayer. *See, e.g., DaimlerChrysler Servs. N. Am., LLC v. Ariz. Dep't of Revenue*, 110 P.3d 1031, 1036 (Ariz. Ct. App. 2005) (citing *Arizona State Tax Commission v. Southwest Kenworth*, 561 P.2d 757, 760 (Ariz. Ct. App. 1977)). Specifically, the retail classification for transaction privilege tax found at A.R.S. § 42-5061 imposes the tax on the "gross proceeds of sales or gross income derived from the business." By statutory definition, "gross proceeds of sales" and "gross income" broadly includes, among other things, "the value proceeding or accruing from the sale of tangible personal property" without any deduction on account of the cost of

property sold, materials used, labor or service performed, interest paid, expense of any kind or losses. *See* A.R.S. §§ 42-5001(5), 42-5001(7). Consequently, a taxpayer's various costs incurred in such areas are generally subject to tax unless otherwise exempted by statute.

There are two potentially operative exemptions in responding to this comment: A.R.S. §§ 42-5061(A)(1) and (A)(2). A.R.S. § 42-5061(A)(1) exempts the gross proceeds of sales or gross income derived from "[p]rofessional or personal service occupations or businesses which involve sales or transfers of tangible personal property only as inconsequential elements." A.R.S. § 42-5061(A)(2) exempts the gross proceeds of sales or gross income derived from "[s]ervices rendered in addition to selling tangible personal property at retail."

A.R.S. § 42-5061(A)(1) exemption

Regarding application of the A.R.S. § 42-5061(A)(1) exemption, the Department has explained that professional and personal service occupations "are those wherein the professional is able to engage in the occupation by virtue of a state sanctioned or state issued license to engage in that occupation" (*e.g.*, lawyers, doctors, cosmeticians, etc.), whereas examples of "service businesses," which are also covered by the exemption, include "vehicle maintenance garages, pest control, lawn maintenance and other like services." *See* Ariz. Transaction Privilege Tax Ruling 90-2 (Aug. 1, 1990). In the context of a professional or personal service occupation or service business, "the services are geared toward the particular needs of the customer with the final product/service meeting those specific needs" wherein the final product need not be in tangible form, and the

exemption generally covers those inconsequential sales or transfers of tangible personal property that are utilized by the person engaged in the occupation or business in the actual operation thereof or to facilitate the service (*e.g.*, shampoo used by a hair stylist to wash a customer's hair). *Id.* Assuming they meet the inconsequentiality test now provided under A.A.C. R15-5-104(C), such sales and transfers are exempt from transaction privilege tax under A.R.S. § 42-5061(A)(1), while the sales or purchases of the tangible personal property *to* the occupation or business (*i.e.*, the final consumer of the property for taxation purposes) would be subject to either transaction privilege or use tax. In contrast, sales or transfers of tangible personal property that fall outside the scope of the exemption include sales of items that are not tailored specifically to a particular customer and are otherwise normally available from a merchant in a retail transaction (*e.g.*, hair salon's sale to a customer of a bottle of shampoo). *See id.* Such transactions would be subject to transaction privilege tax under A.R.S. § 42-5061, unless another exemption applies.

For purposes of the comment, a business could exclude costs such as editing if: (1) the business constitutes either a professional or personal service occupation or a service business and (2) the sale or transfer of the tangible personal property meets the inconsequentiality test currently provided in A.A.C. R15-5-104(C). The business of photography is not a professional or personal service occupation, as one does not enter into the business by virtue of a state sanctioned or state-issued license. Moreover, as is evident by a historical review of the Department's administrative regulation in the area, the business of photography as defined has

been taxable under the retail classification and is not considered a service business. See A.A.C. R15-5-150 (amended effective Aug. 9, 1993) (a photographer's gross receipts derived from sales of photography—"the operation of taking, developing, processing, or printing pictures, prints, or images on or from film, video, or similar media"—are taxable under the retail classification); A.A.C. R15-5-1836 (Supp. 81-2) ("[s]ales by photographers of pictures taken and printed by them are taxable as retail sales," and "developing of films and making of prints of pictures taken by others, are taxable sales"). Consequently, assuming that the business implicated in the tax practitioner's comment engages in sales of photography and does not constitute a professional or personal service occupation, it would have to constitute a service business to fall within the A.R.S. § 42-5061(A)(1) exemption. While a business that engages in a wide spectrum of activities may constitute such a "service business," a business that only makes sales of photography as defined in the rules would not constitute a service business, as it is engaged in business activity subject to tax under the retail classification.

A.R.S. § 42-5061(A)(2) exemption

In *Arizona Transaction Privilege Tax Ruling* TPR 93-31 (May 10, 1993), the Department provided that the A.R.S. § 42-5061(A)(2) exemption generally applies to gross income derived from service activities rendered in addition to retail sales that fall into one (or more) of three categories: (1) repair labor, (2) installation labor, and (3) instruction and training. Nevertheless, TPR 93-31 explained that the three categories "are not intended to be an exclusive listing."

Consequently, the A.R.S. § 42-5061(A)(2) exemption could cover other services that are rendered in addition to a retail sale *if*, like the three categories of services described above, the services are performed separate from—and thus "in addition to"—the sale of tangible personal property.

To address one of the practitioner's concerns (*i.e.*, the inclusion of a photographer's fees for the process of taking images in the photographer's taxable gross receipts for the sale of photography), if a retailer-taxpayer creates the tangible personal property it subsequently sells at retail, activities that fall within the scope of the exemption would have to be distinct from those involved in the actual creation of the tangible personal property at issue. The principle is that, to constitute exempt gross receipts derived from a service "in addition to" the sale, such exempt receipts cannot include taxable gross receipts derived from the vendor's costs of selling at retail, which, in the instance of a vendor that creates the property it subsequently sells, would include costs it passes on to the consumer for creating the product. *See State Tax Comm'n v. Holmes & Narver, Inc.*, 548 P.2d 1162, 1165 (Ariz. 1976); *Trico Elec. Co-op. v. State Tax Comm'n*, 288 P.2d 782, 784 (Ariz. 1955); *Walden Books Co. v. Ariz. Dep't of Revenue*, 12 P.3d 809, 812 (Ariz. Ct. App. 2000); *City of Phoenix v. Ariz. Rent-a-Car Sys., Inc.*, 893 P.2d 75, 79 (if activities of the taxpayer are incidental such that they are inseparable from the principal business and interwoven with the operation thereof to the extent that they are in effect an essential part of the major business, they will not be treated as a separate business for taxation purposes). *See also Walden Books*, 12 P.3d at 812 (income from services that are part of retail sales are

included in the retail classification tax base because they are not services rendered in addition to selling tangible personal property at retail).

As was alluded to by the tax practitioner's comment, services provided in connection with a sale of photography that do not constitute an activity that is part of the process of "photography" as defined—to wit, taking and supplying the customer with an image—could constitute services rendered in addition to the sale of tangible personal property and be exempt under A.R.S. § 42-5061(A)(2). Nevertheless, many fees for intermediary activities that are part of the process of supplying a customer with a photographic image are part of a photographer's taxable gross receipts for the sale of photography, such as charges for the editing and production of images as well as sitting fees. Consequently, the Department has not included a general reference to "editing" services in the examples provided under A.A.C. R15-5-104(C).

Due to the level of elaboration that was necessary under the wording of A.A.C. R15-5-150(B) as provided in the Notice of Supplemental Proposed Rulemaking and resulting confusion caused by it, the Department has provided additional language that should assist readers in recognizing the application of the A.R.S. §§ 42-5061(A)(1) and (A)(2) exemptions to sales of photography (see Paragraph 10(k) *supra*).

- f. *Comment:* The Department received an oral comment from a tax practitioner inquiring about the distinction in tax treatment between taxable sales of photography as addressed by A.A.C. R15-5-150 and certain nontaxable sales of commissioned artwork under A.A.C. R15-5-151. Specifically, he asked whether

the rule could address differences between forms of photography such as commercial advertising photography and portrait photography.

Response: As discussed in A.A.C. R15-5-151(C), a creating artist's sale of a *painting, drawing, etching, sculpture, or piece of craftwork* that is not a reproduction of an original work is nontaxable if the sale constitutes either a casual sale as defined in A.A.C. R15-5-2001(1) or "commissioned artwork"—that is, a "custom, one-of-a-kind art creation made by the individual artist pursuant to the particular requirements of a specific purchaser." Otherwise, the gross receipts of any person making regular sales of "paintings, drawings, etchings, sculptures, craftwork, other artwork or reproductions of such items to final consumers" are taxable, as explained in A.A.C. R15-5-151(A).

For purposes of A.A.C. R15-5-150, the "creations" at issue would be photographic images. Such an image can constitute artwork that is produced pursuant to a specific purchaser's particular requirements, but does not constitute a "painting, drawing, etching, sculpture, or a piece of craftwork" in the plain and ordinary meaning of these terms. Consequently, even if a photographic image constitutes artwork, the gross receipts of the photographer as the creating artist would be nontaxable only if the sale of the image is a casual sale—"an occasional transaction of an isolated nature made by a person who is not engaged in the business of selling, within or without the state, the same type or character of property as that which was sold." *See* A.A.C. R15-5-2001(1).

Based on this tax treatment, distinctions between forms of photography would not be relevant. Consequently, the Department does not perceive a need to amend the rules to address them.

- g. *Comment:* The Department received an oral comment from an industry representative that expressed confusion over the term "digital printing" used as an example of a job printing activity under A.A.C. R15-5-1101(B).

Response: The Department agrees that the example causes unnecessary ambiguity and confusion and has deleted the term from the list of examples. This change has also been noted in Paragraph 10(f) *supra*.

- h. *Comment:* In an oral comment, an industry representative asked for further clarification regarding the tax treatment of activities in which printing is distributed to a large number of recipients located within and without the state (*e.g.*, by direct mail or broadcast fax), due to the exemption under A.R.S. § 42-5066(B)(2) for printing shipped or delivered out of Arizona for use outside the state.

Response: The Department has amended A.A.C. R15-5-1102 by adding a subsection (E) that provides taxpayers with a general explanation of the exemption and an example of how they may substantiate such exempt sales. The change has also been noted in Paragraph 10(g) *supra*.

- i. *Comment:* In written comment, two industry representatives asked for further clarification of the applicability of the retail classification exemptions under A.R.S. § 42-5061 to sales of materials to job printers.

Response: The Department has amended A.A.C. R15-5-1106 to specifically include a reference to A.R.S. § 42-5061 exemptions. The change has also been noted in Paragraph 10(h) *supra*.

- j. *Comment:* In an oral comment, a tax practitioner asked if the list in A.A.C. R15-5-150(B) of the level of services that qualify the sale of photography as an inconsequential element could be expanded to include: photography fees (*i.e.*, for taking shots); creative fees; production; fees paid to stylists, assistants, and producers; assistance; fees for image editing (*e.g.*, manipulation of digital images with Adobe Photoshop[®]); charges for delivery by traditional or electronic means, and location scouting fees.

Response: The Department's response to the comment in Paragraph 11(e) *supra* provides an explanation of why the Department has decided not to include photography fees; creative fees; production; fees paid to stylists, assistants, and producers; and fees for image editing in the list. The Department also believes that including "assistance" in A.A.C. R15-5-150(B) would create greater confusion rather than provide additional guidance because of overly broad nature of the term. Delivery charges are already separately addressed by A.A.C. R15-5-133 for the purpose of all transactions subject to tax under the retail classification. The Department has amended the examples in A.A.C. R15-5-150(B) to include a reference to location scouting fees. This change is also noted in Paragraph 10(d) *supra*.

- k. *Comment:* The Department received an oral comment expressing confusion over the term "digital or analog storage medium" used in A.A.C. R15-5-150(A), R15-

5-1101(A), and R15-5-1101(C) of the September 3, 2004 Notice of Supplemental Proposed Rulemaking.

Response: Upon review, the Department determined that the term “digital or analog” describes forms of images that can be stored by any medium used in photography, and does not clarify that qualifying media can be anything capable of storing images. Consequently, the Department has decided to amend the rules by using the more generic term “data storage medium,” as noted in Paragraph 10(a) *supra*.

1. *Comment:* A tax practitioner submitted an oral comment to the Department after the close of the official comment period inquiring whether the term "production activities" as used in A.A.C. R15-5-150(B) is limited in scope to those activities associated with production of a motion picture.

Response: Courts interpret administrative rules using the same method applied for statutes, interpreting them "to result in a fair and sensible meaning, giving the words and phrases used their ordinary meanings unless the context indicates otherwise." *See Samaritan Health Servs. v. Ariz. Health Care Cost Containment Sys. Admin.*, 875 P.2d 193, 196 (Ariz. Ct. App. 1994). The term "production activities" is not defined in A.A.C. R15-5-150 or elsewhere in the Article, as the Department intended for the plain and ordinary meaning of the term to be used. A standard dictionary definition for "production" reveals that the term can mean, *inter alia*: "something that is produced naturally or as the result of labor and effort : PRODUCT"; "a literary or artistic work," "theatrical representation," or "an action resembling an elaborate theatrical performance"; and "the act or process of

producing, bringing forth, or making." WEBSTER'S THIRD NEW INTERNATIONAL DICTIONARY OF THE ENGLISH LANGUAGE UNABRIDGED 1810 (1993).

Upon reviewing this definition, the Department believes that the practitioner's concern that the term could be interpreted to only apply to motion picture production activities is reasonable. Consequently, the Department has decided to amend the rules to address this issue as part of the changes described in Paragraph 10(k) *supra*.

- m. *Comment:* An industry association representative submitted an oral comment after the close of the official comment period inquiring whether the job printing classification rules could be amended to exempt a printer's gross income derived from postage fees when the fees are separately stated and the printer has included no markup to its customer.

Response: A.R.S. § 42-5066, which addresses the job printing classification, does not provide an exemption for gross income derived from services that might be characterized as ancillary or in addition to sales of taxable activities, such as charges for shipping and handling; consequently, an administrative rule cannot provide for such an exemption. A.A.C. R15-5-1102(A) reflects this rationale in providing that "[g]ross income or gross proceeds derived from all of a printer's costs or expenses of filling a customer's printing order are subject to tax under this Article."

- n. *Comment:* An industry association representative submitted an oral comment after the close of the official comment period inquiring whether the third sentence of the definition of "job printing" found at A.A.C. R15-5-1101(2) could be amended

by deleting the reference to "inkjet printing" as an example of job printing. The representative stated that members of their association that constitute "mailing houses" regularly print, using inkjet printing techniques, mailing address information to mass-mailed media (*e.g.*, store catalogs) as part of their business of distributing the mass mailings on behalf of their customers. The representative stated that these mailing houses do not consider themselves subject to tax under the job printing classification and are not currently remitting transaction privilege tax on the gross receipts of such inkjet printing activity.

Response: Before responding directly to the concern raised in the comment, the Department recognized potential confusion caused by the wording of the third sentence of A.A.C. R15-5-1101(2), in that it purports to provide a list of "[e]xamples of job printing activities." In actuality, the sentence provides a list of methods by which job printing can be performed. Thus, for instance, a printer subject to tax under the job printing classification is taxable on its gross receipts derived from charges for photocopying performed for a client, whereas a law firm that is not subject to tax under the job printing classification is not taxable on its gross receipts derived from charges to a client for providing a photocopy of work product. For clarification purposes, the sentence has been amended as described in Paragraph 10(l) to specify that the list provides examples of methods of job printing.

Upon review, the Department can find no distinction to justify the removal of inkjet printing—used in the rule to refer generally to the method of printing wherein characters, images, and other data are produced by projecting electrically

charged ink onto a surface. If a business described as a mailing house by the industry representative derives gross receipts from the business of copying or reproducing customer-provided data in a manner described in the definition at A.A.C. R15-5-1101(2), then the Department would consider the business's gross receipts subject to tax under the job printing classification. Whether any portion of the business's gross receipts beyond those derived from inkjet printing fall within the tax base for the classification in such a scenario would be determined using the three-part test enunciated by the Arizona Supreme Court in *State Tax Commission v. Holmes & Narver, Inc.*, 548 P.2d 1162 (Ariz. 1976). The test generally provides that if: (1) it can be readily ascertained without substantial difficulty which portion of the business is for services other than those subject to tax under the classification, (2) the amounts in relation to the company's total taxable business under the classification are not inconsequential, and (3) the services at issue cannot be said to be incidental to the taxable business, the gross income derived from such services are not included as part of the tax base for the business and are not subject to tax. *See* 548 P.2d at 1166.

The *Holmes & Narver* test, also known colloquially as the "separate-line-of-business" test, is applicable across transaction privilege tax classifications and, as such, is not a principle unique to the job printing classification. As such, the Department concludes that it would be inappropriate to include specific reference to the test in A.A.C. Title 15, Chapter 5, Article 11, which is limited in application to the job printing classification.

- o. *Comment:* An industry association representative submitted an oral comment to the Department after the close of the official comment period, inquiring whether gross income derived from activities that are performed by a printer subject to tax under the job printing classification but that are not specified as being part of the tax base under A.R.S. § 42-5066 can be separated from the printer's taxable business by way of separate contracts.

Response: Contract bifurcation alone is not conclusive in whether gross receipts derived from a particular activity are subject to tax, and indeed, the *Holmes and Narver* court stated that "[s]uch a conclusion would honor substance over form." 548 P.2d at 1165-66. The appropriate analysis has been described in Paragraph 11(n) *supra*.

- p. *Comment:* The Department received written comment from a tax practitioner after the close of the official comment period, repeating a concern the practitioner previously raised as part of comments on the March 5, 2004 Notice of Proposed Rulemaking regarding A.A.C. R15-5-1106. The rule in the March 5 notice provided that the gross proceeds of sales to a printer of materials that do not become an ingredient or component part of a printing are "subject to tax under the retail classification . . . unless exempt." Nevertheless, since the subsequent September 3, 2004 Notice of Supplemental Proposed Rulemaking, the rule has provided that "[s]ales to a printer" of such materials "fall under the retail classification . . . and are subject to tax unless otherwise exempt under A.R.S. § 42-5061." Both versions of A.A.C. R15-5-1106 gave, as an example of the materials at issue, "film processing chemicals." The commenter stated that the

language "refers to taxing 'materials that do not become an ingredient or component part of a printing,'" which he asserts is erroneous in the case of film processing materials because "[a]pproximately 68% of the photo processing chemicals do, in fact, become ingredient and component parts of the finished product" and "are transferred to the ultimate customer, at least in the photo processing industry."

Response: A.A.C. R15-5-1106 does not discuss whether sales to a printer of materials that do not become an ingredient or component part of a printing are subject to tax, because the ultimate taxability of such materials does not depend on whether they become ingredient or component parts. Rather, the rule states that such sales are considered within the framework of the A.R.S. § 42-5061 retail classification, and consequently, in light of the numerous exemptions applicable for that classification. For instance, A.R.S. § 42-5061(A)(39) exempts from transaction privilege tax gross receipts derived from sales of "liquid, solid or gaseous chemicals" used in

printing, if using or consuming the chemicals, alone or as part of an integrated system of chemicals, involves direct contact with the materials from which the product is produced for the purpose of causing or permitting a chemical or physical change to occur in the materials as part of the production process.

The specific inclusion of film processing chemicals to the rule in A.A.C R15-5-1106 responds to the prior inquiries to the Department regarding the applicability of transaction privilege tax to sales of such chemicals, and in which the

Department had to reference to A.R.S. § 42-5061(A)(39) exemption under the retail classification. *See* Ariz. Private Taxpaying Ruling LR03-004 (May 9, 2003). The plain language of the rule does not state a determination of taxability for sales of such materials, but rather, directs the reader to look to the rubric of the retail classification rather than the job printing classification to analyze whether they are subject to transaction privilege tax.

12. Any other matters prescribed by statute that are applicable to the specific agency or to any specific rule or class of rules:

Not applicable

13. Any material incorporated by reference and its location in the text:

Not applicable

14. Whether the rules were previously made as emergency rules and, if so, whether the text was changed between the making as emergency and the making of the final rules:

Not applicable

15. The full text of the rules follows:

TITLE 15. REVENUE
CHAPTER 5. DEPARTMENT OF REVENUE
TRANSACTION PRIVILEGE AND USE TAX SECTION
ARTICLE 1. RETAIL CLASSIFICATION

Section

R15-5-150. Sale of Photography

ARTICLE 11. SALES TRANSACTION PRIVILEGE TAX – JOB PRINTING
CLASSIFICATION

Section

R15-5-1101. ~~Repealed~~ Definitions

R15-5-1102. ~~Repealed~~ Printer's Sale of Printing

R15-5-1103. ~~Examples of printed articles~~ Repealed

R15-5-1104. ~~Definitions~~ Repealed

R15-5-1105. ~~Printing facilities located out of state~~ Repealed

R15-5-1106. ~~Sale of materials~~ Materials to a Printer

R15-5-1107. ~~Typesetting services~~ Repealed

R15-5-1109. ~~Interstate and Foreign Transactions~~ Repealed

R15-5-1111. ~~Cost of printing~~ Miscellaneous Costs of a Printer Are Not Deductions

R15-5-1112. ~~Photography~~ Sale of Image Developing

TITLE 15. REVENUE
CHAPTER 5. DEPARTMENT OF REVENUE
TRANSACTION PRIVILEGE AND USE TAX SECTION
ARTICLE 1. RETAIL CLASSIFICATION

R15-5-150. Sale of Photography

A. ~~The following definitions apply for purposes of this rule: In this Section:~~

1. ~~“Photographer” means a person who engages in the business of photography.~~

"Motion picture" has the same meaning as prescribed in A.R.S. § 41-1517.

~~2. "Motion picture production company" has the same meaning as prescribed in~~

A.R.S. § 41-1517.

~~2. 3. “Photography” means the operation process of taking, developing, processing, or printing pictures, prints, or and supplying images on or from to customers, using film, video, or other similar media~~ another data storage medium.

4. "Qualified motion picture production company" means a motion picture production company that holds a valid certificate issued pursuant to A.R.S. § 42-5009(H), establishing the company's qualification for the A.R.S. § 42-5061(B)(23) exemption.

B. ~~Gross receipts derived from sales~~ Gross income or gross proceeds derived from a sale of photography by a photographer are taxable subject to tax under the retail classification this Article, unless, under A.A.C. R15-5-104(C), the sale of such photography is considered an inconsequential element of nontaxable activities that are associated with the sale. Examples of nontaxable activities that are associated with a sale of photography

include research; script consulting; director, crew, and equipment charges; preproduction or postproduction charges; location scouting fees; and music charges. Activities that are associated with the sale of photography are nontaxable if one of the following applies:

1. The vendor is engaged in both a professional or personal service occupation or a service business under A.R.S. § 42-5061(A)(1) and the business of selling photography at retail;
or
 2. The activities are not part of the manufacture, creation, or fabrication of photography and are not otherwise subject to tax under another Article of this Chapter.
- C. ~~Developing of films and making of prints of pictures taken by others are taxable. Developing and printing for drugstores and other retailers are sales for resale. Gross income or gross proceeds derived from a sale of photography used directly in motion picture production by a qualified motion picture production company are exempt from tax under this Article pursuant to A.R.S. § 42-5061(B)(23).~~

ARTICLE 11. SALES TRANSACTION PRIVILEGE TAX – JOB PRINTING

CLASSIFICATION

R15-5-1101. ~~Repealed~~ Definitions

For purposes of this Article, the following definitions apply:

1. “Image developing” means the copying or reproducing by a printer of an image by any means from film, paper, video, or another data storage medium to photographic print paper or another storage medium that can visually display the image.
2. “Job printing” means the copying or reproducing by a printer of documents or data

directly or indirectly provided by the printer's customer, including by another person at the customer's direction, for the ultimate purpose of producing a physical or electronic copy of the document or data. The document or data can be textual or pictorial, and may be received by the printer in physical or electronic form. Examples of methods of job printing include dye sublimation, electrostatic printing, flexography, gravure, inkjet printing, laser printing, lithography, offset printing, optical scanning, photocopying, photofinishing, reprographic printing, screen printing, thermography, xerography, and similar means of duplication.

3. "Photography" means the process of taking and supplying images to customers, using film, video, or another data storage medium.
4. "Printer" means a person that copies or reproduces textual or pictorial material by any means, process, or method of job printing, engraving, embossing, or copying, but that does not distribute the copied or reproduced material on the person's own behalf.
5. "Printing" means a finished product in physical or electronic form produced by a printer through job printing, engraving, embossing, or copying and that is held for sale by the printer.
6. "Qualifying health care organization" has the same meaning as prescribed in A.R.S. § 42-5001(10).
7. "Qualifying hospital" has the same meaning as prescribed in A.R.S. § 42-5001(11).

R15-5-1102. ~~Repealed~~ Printer's Sale of Printing

- A.** Gross income or gross proceeds derived from all of a printer's costs or expenses of filling a customer's printing order are subject to tax under this Article. Examples of costs or

expenses include charges for set-up, die cutting, embossing, folding, and binding operations.

B. Gross income or gross proceeds derived from an Arizona printer's sale of printing within Arizona are subject to tax even when the printer conducts the job printing, engraving, embossing, or copying activity outside the state, unless the printing is shipped or delivered outside the state for use outside the state.

C. If a printer ships or delivers printing to be used outside the state to a common carrier for transportation to a location outside the state, the common carrier is deemed to be the agent of the printer for purposes of determining whether the printing has been shipped or delivered outside the state, regardless of who is responsible for payment of the freight charges.

D. A printer may substantiate a shipment or delivery of printing outside the state by one of the following records:

1. An internal delivery order that is supported by receipts for expenses incurred in delivery of printing and signed on the delivery date by the person who delivers the printing;
2. A common carrier's receipt or bill of lading;
3. A parcel post receipt;
4. An export declaration;
5. A receipt from a licensed broker; or
6. Proof of export or import, signed by a customs officer.

E. Gross income or gross proceeds derived from an Arizona printer's charges for the distribution of printing are generally subject to tax under this Article. In the absence of

documentation listed in subsection (D), it remains the taxpayer's burden to substantiate that the gross income or gross proceeds derived from a sale of printing are not taxable because the printing is shipped or delivered outside the state for use outside the state, pursuant to A.R.S. § 42-5066(B)(2). A printer substantiates that printing is shipped or delivered outside the state for use outside the state if the printer shows that the address or number to which the printer distributes the printing does not identify or is incapable of identifying an in-state location.

~~R15-5-1103. Examples of printed articles Repealed~~

~~The printing or other reproduction of books, periodicals, magazines, business or professional stationery, and of any other articles copied or reproduced by printers, engravers, embossers, or copiers, is included under this classification.~~

~~R15-5-1104. Definitions Repealed~~

~~A printer is defined as any person who copies or reproduces an article by any means, process, or method. A printer is subject to the tax, even though conducting the actual printing outside the state, unless the end product is sold outside the state to out-of-state purchasers. Examples include: multigraphing, lithographing, photostating, multilithing, and other similar means of duplicating.~~

~~R15-5-1105. Printing facilities located out of state Repealed~~

~~A printer in this state is subject to the tax on his income from sales within this state even though the printing or reproduction equipment is located in another state.~~

R15-5-1106. Sale of materials Materials to a Printer

- ~~A.~~ The income from sales made by a job printer of materials on which no printing or other reproduction is done is subject to tax under the retail classification (see Article 18).
- ~~B.~~ The sale Sales to a printer of articles materials which that do not become a an ingredient or component part of the printed or reproduced item a printing is subject to tax fall under the retail classification (see Article ~~18~~ 1 of this Chapter) ~~when sold to a user or consumer~~ and are subject to tax unless otherwise exempt under A.R.S. § 42-5061. Examples of such ~~articles~~ materials include: color process plates, electrotypes, color process plates, film processing chemicals, printing plates, and wood mounts. In contrast, sales by the printer of any such materials that are job printed, engraved, embossed, or copied by the printer for the printer's customer constitute sales of printing and fall under this Article. An example is a printer's sale to a customer of a printing plate upon which the printer has performed job printing, engraving, embossing, or copying activity for the customer.

R15-5-1107. ~~Typesetting services~~ Repealed

~~Casting and setting monotype, linotype, and photoplates for others are deemed to be services and are not subject to tax. Income from reproduction proofs furnished to a printer in connection with these services is not taxable. However, sales of reproduction proofs to non-printers are taxable.~~

R15-5-1109. ~~Interstate and Foreign Transactions~~ Repealed

- ~~A.~~ Gross receipts from sales of job printing, engraving, embossing or copying made in interstate or foreign commerce by a vendor within this state are deductible from the tax

~~base if the vendor ships or delivers the job printing to a location outside of Arizona for use outside of Arizona.~~

B. ~~In meeting the above requirement, if delivery is made by the vendor to a common carrier for transportation to a location outside Arizona, the common carrier is deemed to be the agent of the vendor for purposes of this rule regardless of who is responsible for payment of the freight charges.~~

C. ~~Suitable records for substantiating out of state shipments may include:~~

- ~~1. Internal delivery orders supported by receipts of expenses incurred in delivering the property and signed on the delivery date by the person who delivers the property;~~
- ~~2. Common carrier's receipt or bill of lading;~~
- ~~3. Parcel post receipt;~~
- ~~4. Export declaration;~~
- ~~5. Receipt from a licensed broker; or~~
- ~~6. Proof of export or import signed by a customs officer.~~

R15-5-1111. ~~Cost of printing~~ Miscellaneous Costs of a Printer Are Not Deductions

A. ~~A job printer who sublets the printing or other reproduction of an article may not deduct the cost thereof~~ shall not deduct the cost of subletting job printing, engraving, embossing, or copying activities.

B. ~~A job printer may~~ shall not take a deduction for deduct the cost of labor or materials employed in the job printing, engraving, embossing, or copying activity of another person.

R15-5-1112. Photography Sale of Image Developing

- A.** ~~Photography does not fall within this classification but is included under the retail classification (see Article 18).~~ Gross income or gross proceeds derived from a sale of image developing in which the image developing is not part of a sale of photography are subject to tax under this Article.
- B.** Gross income or gross proceeds derived from a sale of image developing to a business that resells the image developing are nontaxable under this Article.
- C.** Gross income or gross proceeds derived from a sale of image developing either to a qualifying health care organization that uses the image developing solely to provide health and medical related educational and charitable services or to a qualifying hospital are nontaxable under this Article. An example is image developing of x-ray film or photographs.