STATE OF ARIZONA
Department of Revenue

Douglas A. Ducey
Governor

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Director

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Via email: jstielow@arizonatax.org

Mr. Kevin McCarthy
President
Arizona Tax Research Association
1814 W Washington St.
Phoenix, AZ 85007

Dear Mr. McCarthy:

Thank you for your letter dated January 18, 2022 on behalf of the Arizona Tax Research Association ("ATRA"). ATRA's letter provided comments to the Department's draft server ruling, which addresses whether income derived from remotely accessed webhosting and servers is subject to the Arizona transaction privilege tax ("TPT") as a personal property rental.

ATRA has several objections to the ruling. However, ATRA's main objection is that the income derived from remotely accessed webhosting and servers is not taxable under the personal property rental classification. Rather, ATRA asserts this activity should be considered a nontaxable service. ATRA also has some general concerns about whether the Department has the authority to issue the ruling, as well as whether the ruling will be applied prospectively. Finally, ATRA is concerned that while the Department is providing guidance for this one specific area related to digital goods, there are other areas dealing with digital goods that need clarification. The Department addresses these concerns below.

1. The Department believes the activity in question is taxable as the rental of tangible personal property.

The vast majority of ATRA's objections to the ruling are based on the fact that it believes the activity the Department affirmatively says is taxable is, in fact, not taxable. ATRA makes several arguments to support this claim including the following:

- generally, the terms of a server-type agreement indicate it is a service;
- a service is the object of the transaction;
- the customer is not able to physically move the property; and

- when a comparison is made between other similar types of activities, this activity is a more accurate fit with a service characterization than with the rental of tangible personal property characterization.

Since 2013, the Department has had many opportunities to review fact specific situations dealing with server hosting, including situations where the parties characterize the arrangement as a service. From those reviews, the Department agrees that taxpayers have traditionally labeled server hosting as a service. Taxpayers are free to attach whatever name to their arrangements as they feel appropriate. However, the Department's role in determining whether an activity is taxable is to examine what is being offered, how it is being offered and whether the activity falls into one of Arizona's sixteen TPT classifications. The Department has done an extensive analysis in this case and made a determination that server hosting is taxable as the rental of tangible personal property based on the circumstances outlined in the proposed ruling.

The Department determined the object of the transaction was not a service, as there is no human element involved anywhere in the process. None of the items in the letter listed as typical limitations on possession of the server is indicia of a service. Moreover, it is not uncommon to have restrictions on a renter's use of tangible personal property in a rental arrangement[1]; those restrictions do not make the arrangement a service. Furthermore, in the Department's experience, in cases where there *is* a service (*i.e.*, human) element involved in a lease arrangement, the service element is only provided to facilitate the underlying lease of tangible personal property. In cases where a taxpayer believes that due to the uniqueness of their offering, a service the dominant purpose of the transaction, the Department is happy to examine those facts and circumstances and make a determination.

ATRA insists that *Peck*[2] requires that the property being rented must be physically capable of being transported from one place to another by the customer.[3] In fact, what *Peck* states is that "*[w]e **do not believe** that the terms 'leasing' or 'renting' as used in the statute require that property so leased or rented be physically capable of being transported from one place to another by the customer*." In other words, it is not necessary that the customer be able to move the property. In addition, the *Peck* court

[1] Examples include prohibiting a lessee from using the property for an illegal purpose or making changes to the property not authorized by the rental agreement.
[2] *State Tax Commission v. Peck*, 106 Ariz. 394 (1970).
[3] See ATRA letter, page 8.

recognized that what is necessary to constitute a rental is that the customers themselves exclusively control all manual operations necessary to run the machines:

> It is also true that the customers themselves exclusively control all manual operations necessary to run the machines. In our view such exclusive use and control comes within the meaning of the term 'renting' as used in the statute.[4]

Notably consistent with *Peck* is the fact that the Department does not base its determination of the taxability of the server offering on the control of a specific server or the underlying code. Rather, it bases its taxability determination on the ability of the customer to use and control the server that is provisioned for its use and the desired operating system functions needed for the particular use. The proposed ruling provides as follows:

> A taxable rental requires a contract for exclusive use and control of the manual operations of the tangible personal property for a specified time and specified consideration. . . . A dedicated server or virtual private server customer has exclusive use and control of the server's operating system, or in other words, the customer has control of the manual operations of the tangible personal property which they are renting.[5]

Accordingly, the Department believes it's analysis is specifically in line with *Peck* and Arizona law on the rental issue.

2. Other issues.

ATRA's other concerns deal with the scope of the Department's authority to issue a ruling in this area. ATRA urges the Department to apply the ruling prospectively if, in fact, the Department is acting within its authority.

Over the years, the Department has issued rulings on a wide variety matters in areas where the Department believes taxpayers need assistance in understanding a specific taxable activity. The Department believes this is one such area. Moreover, the Department believes that software is tangible personal property and that the rental of

[4] *State Tax Commission v. Peck*, 476 P.2d 849, 851, 106 Ariz. 394, 396 (Ariz. 1970)
[5] Page 5 of proposed server ruling.

such property meeting the *Peck* standard constitutes a taxable rental of tangible personal property. As explained above, the analysis of server hosting meets this criteria and, accordingly, the Department believes it is acting well within its statutory authority.

ATRA's other concerns include whether the Department will apply the ruling prospectively and how taxpayers should deal with other areas of digital goods that are not clear. The Department recognizes there might be some misunderstanding about whether server hosting is taxable and therefore undertakes to apply the ruling prospectively. In relation to other areas of digital goods, although the Department has not yet issued any rulings, it may determine the need to issue additional rulings on such topics in the future. Moreover, the Department answers taxpayer questions related to digital goods, software or any other area, as requested, on a daily basis. Questions related to specific taxpayer activity should be sent to AskTaxPolicy@azdor.gov. In addition, the Department has many resources that provide a wealth of information on its website.

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

Sincerely,

Lisa Querard

Lisa Querard
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Arizona Department of Revenue