BEFORE THE ARIZONA DEPARTMENT OF REVENUE

In the Matter of [REDACTED] EIN # [REDACTED]	)	DECISION OF HEARING OFFICER Case No. 201800188-C

A hearing was held on June 20, 2019 in the matter of the protest of [REDACTED] (Taxpayer) to a refund denial by the Corporate Income Tax Audit Section (Section) of the Arizona Department of Revenue (Department) for tax years [REDACTED]. Prior to the hearing, Taxpayer withdrew its protest of the Modification of Notice of Proposed Assessment dated October 17, 2018 for tax years [REDACTED].

Taxpayer and the Section timely filed their respective post-hearing memoranda. Therefore, this matter is ready for ruling.

FINDINGS OF FACT

1. Taxpayer is a [REDACTED] company specializing in the design, manufacture, and marketing of electronic gaming equipment and systems.
2. Taxpayer was incorporated in [REDACTED].
3. Taxpayer's significant revenue streams include sales and leases of various gaming equipment, revenue from its proprietary Wide Area Progressive ("WAP") systems, sales of casino management systems and parts, and licenses. Taxpayer has reported Arizona sales and leases of gaming equipment (i.e., non-WAP revenue) in the numerator of its Arizona sales factor.
4. Taxpayer enters into agreements with casinos pursuant to which Taxpayer creates and provides access to its proprietary WAP machines to various casinos and, in exchange, receives a portion of the gamblers' wagers.

5. Taxpayer's WAP machines operate as part of Taxpayer's WAP System ("System"), which enables WAP machines in different casinos to be electronically linked to a progressive jackpot.

6. All of Taxpayer's Arizona WAP agreements were signed in [REDACTED] by the subsidiary [REDACTED].

7. In Arizona, Taxpayer's WAP System is offered solely to [REDACTED].

8. WAP agreements are one-time agreements. Taxpayer and a casino sign one WAP agreement that applies in perpetuity to all WAP machines Taxpayer installs on the casino's floor.

9. Taxpayer manufactures WAP machines after Taxpayer enters into a WAP agreement with a casino, which must be manufactured to meet the specific requirements of the relevant jurisdiction's gaming authority.

10. Taxpayer's obligations under WAP agreements include:

    A. Manufacturing all WAP machines in its manufacturing facility located in [REDACTED] specifically for each contract;

    B. Installing its proprietary WAP machines and related equipment at a mutually agreeable position on the main gaming floor of the casino;

    C. Making modifications to the WAP machines, in its sole discretion, to improve the payout odds and increase probable size of progressive jackpot.

11. The casino agrees not to relocate the WAP machines from such positions without prior approval from Taxpayer.

12. Taxpayer provides dedicated telephone lines connecting its central accounting system with the casino's communication device to establish necessary communication between the WAP machines and Taxpayer's monitoring facility located in [REDACTED].

13. Jackpot payout amounts are set by Taxpayer's personnel located at the 24-hour monitoring center in [REDACTED].

14. Taxpayer is responsible for funding and paying the top progressive jackpots using its share of the wagers from all WAP machines linked to a particular jackpot.

15. Taxpayer or its designee agrees to timely pay the top progressive jackpot prizes validly won by players of the WAP machines at the casino's location, or promptly reimburse the casino for payment of the same.

16. Taxpayer agrees to continuously maintain a fund of monies and/or funding assets (government securities), in sufficient amounts or sufficient value to satisfy all outstanding payment obligations to valid winners of the top progressive jackpot prizes.

17. Taxpayer agrees to provide the casino with any associated accounting records and information on a monthly basis, or as agreed between Taxpayer and the casino.

18. Taxpayer's employees, located in [REDACTED], administer the compilation of documentation and correspondence required for audit submissions to regulators, including writing and updating of internal controls required by regulatory agencies.

19. Taxpayer's employees located in [REDACTED] are responsible for daily meter audits, ensuring compliance, unit counts, jackpot contributions, and meter management.

20. The sum of all wagers accepted by the WAP machines at the casino's location is referred to as the Gross Handle.

21. The casino agrees to pay Taxpayer the applicable PSF percentage of the Gross Handle for the respective game, listed in Exhibit B of the Agreement, for use in

conjunction with meeting jackpot payment obligations and as consideration to Taxpayer for performance of their obligations under the agreement.

22. Once a top progressive jackpot has been won, Taxpayer's monitoring center personnel located in [REDACTED], are responsible for, among other things, verifying recognition of the jackpot by the WAP computer system, performing several security checks to verify the validity of the jackpot, preparing and managing payments to jackpot winners, and managing communications with them.

23. The casino agrees to place appropriate security to prevent further play of the machine and to prohibit any opening, power shutdown, or other handling of the WAP machine until a representative of Taxpayer is present.

24. Taxpayer agrees to send a verification representative as soon as commercially practical. Only upon full verification of the validity of the win and confirmation of the correct progressive jackpot amount is payment of the prize initiated.

25. All WAP machine fills and payment of all wins to players (except the top-progressive and mini-progressive jackpot prizes) is the sole responsibility of and timely payable by the casino.

26. The casino undertakes the following responsibilities in exchange for the right to use Taxpayer's WAP machines on its premises:

    A. Provide, establish and maintain appropriate surveillance and exterior security for all System equipment at the casino, as required by the appropriate regulatory authority.

    B. Responsible for and pay the cost of all electrical requirements and utility expenses at the casino, clear coin jams, exterior cleaning, and replace fuses, light bulbs, and standard coin operators. Upon receipt of the replaced fuses

and light bulbs, Taxpayer will send the casino new ones at no cost to the casino.

C. Abide by such security and internal control measures, as Taxpayer requires in relation to the WAP machines and related equipment.

D. Maintain adequate liability and property insurance, for all claims which may arise as a result of their acts or omissions.

27. The System and related equipment are provided by Taxpayer to the casino only for the term of the agreement.

28. The System and related equipment remain the sole and exclusive property of Taxpayer, remains personal property regardless of any attachment to realty, and never becomes security for any obligation of the casino.

29. The WAP agreement continues until either party, for any reason whatsoever, provides 10 days written notice to the other party of intent to terminate.

30. Following termination of a WAP agreement, Taxpayer agrees to timely remove the WAP machines and related equipment from its location and any payment due through the date of termination is to be promptly paid by the casino.

31. Taxpayer may require the casino at any time to remove or disconnect any equipment connected to the System which does not, in Taxpayer's sole discretion, generate sufficient revenues to be profitable or in the event a court of competent jurisdiction and/or applicable regulatory agency so requires.

32. Upon termination of a WAP agreement, the casino agrees to peaceably return possession of all WAP machines and related equipment to Taxpayer in the same condition as when installed, normal wear and tear excluded.

33. The casino grants Taxpayer a non-exclusive and revocable license for the term of the WAP agreement to use the casino's name and registered trademark solely and exclusively in the advertising and promotion of the System.

34. In July 2011, Taxpayer timely filed Arizona amended corporate income tax returns on an Arizona consolidated basis for tax years [REDACTED] and full combined basis for tax years [REDACTED].

35. In the Arizona amended corporate income tax returns for [REDACTED], Taxpayer excluded, from the numerator of the sales factor, receipts related to Taxpayer's WAP machines and System in Arizona.

36. On or about December 16, 2014, Taxpayer received a Notice of Proposed Assessment ("NOPA") from the Section.

37. The NOPA included a refund denial in the amount of $[REDACTED] for the amended corporate income tax returns filed in [REDACTED].

38. The NOPA reflected net tax due of $[REDACTED], plus statutory interest [REDACTED].

39. The NOPA net tax due included an adjustment to add back applicable expenses for non-taxable foreign dividends using the federal Form 1118s prepared by the Taxpayer.

40. On or about January 15, 2015, Taxpayer timely protested the NOPA in its entirety.

41. On or about October 17, 2018, Taxpayer received a modification to the NOPA on issues other than cost of performance, subsequently reducing net tax due to $[REDACTED], exclusive of statutory interest.

42. The modification to the NOPA reduced the adjustment to add back applicable expenses for non-taxable foreign dividends in line with Section's current audit methodology.

43. Taxpayer wishes to engage in direct tracing to show the actual amount of expenses attributable for foreign operations.

CONCLUSIONS OF LAW

1. Arizona Revised Statutes (A.R.S.) § 43-1132(A) provides that any taxpayer having income from business activity which is taxable both within and without this state shall allocate and apportion net income as provided in Title 43, Chapter 11, Article 4.
2. A "taxpayer" is defined in A.R.S. § 43-1101(7) as a corporation.
3. A taxpayer's business income is apportioned to the states where the taxpayer operates. Title 43, Chapter 11, Article 4.
4. Business income means income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations. A.R.S. § 43-1131(1).
5. A taxpayer's business income is apportioned to Arizona based on an apportionment ratio comprised of the taxpayer's property, payroll and sales factors. A.R.S. § 43-1139.
6. The payroll and property factors are not at issue in this appeal.
7. The sales factor includes the gross receipts of the taxpayer derived from transactions and activity in the regular course of a trade or business not specifically allocated. A.R.S. § 43-1131(5); Arizona Administrative Code ("A.A.C.") R15-2D-101.
8. The purpose of the sales factor is to tax an entity for the benefits it receives by exploiting a market in a state. *Walgreen v. Arizona Department of Revenue*, 209 Ariz. 71, 97 P.3d 896 (2004).
9. "The sales factor is a fraction, the numerator of which is the total sales of the taxpayer in this state during the tax period, and the denominator of which is the

total sales of the taxpayer everywhere during the tax period . . .” A.R.S. § 43-1145.

10. Sales of tangible personal property are considered to be in this state if the property is delivered or shipped to a purchaser within this state. A.R.S. § 43-1146.

11. Sales, other than sales of tangible personal property, are in this state if either of the following applies: (1) The income-producing activity is performed in this state. (2) The income-producing activity is performed both in and outside this state and a greater proportion of the income-producing activity is performed in this state than in any other state, based on cost of performance. A.R.S. § 43-1147(A).

12. “The term “income-producing activity” applies to each separate item of income and means the transactions and activities directly engaged in by a taxpayer in the regular course of its trade or business for the ultimate purpose of obtaining gains or profit. . . . Accordingly, “income-producing activity” includes but is not limited to the following:

    a. The rendering of personal services by employees or the use of tangible personal property by the taxpayer in performing a service;

    b. The sale, rental, leasing, licensing, or other use of real property;

    c. The rental, leasing, licensing, or other use of tangible personal property; and

    d. The sale, licensing, or other use of intangible personal property. The mere holding of intangible personal property is not, of itself, an income-producing activity.

    A.A.C. R15-2D-806(1).

13. Gross receipts from the rental, lease, or licensing of tangible personal property are in this state if the property is located in this state. A.A.C. R15-2D-806(3)(b).

14. Gross receipts for the performance of personal services are attributable to this state to the extent the services are performed in this state. If services relating to a single item of income are performed partly within and partly without this state, the gross receipts from the performance of the services are attributable to this state only if the greater proportion of the services is performed in this state, based on cost of performance. A.A.C. R15-2D-806(3)(c).

15. A.R.S. § 42-5071 imposes Arizona's transaction privilege tax on persons engaged in the business of renting or leasing tangible personal property for a consideration.

16. The Section properly denied Taxpayer's claim for refund.

DISCUSSION

The issue to be decided is whether the Section properly denied Taxpayer's claim for refund. In particular, the issue is whether the Section erred in denying Taxpayer's claim for refund based on excluding revenue derived from its Wide Area Progressive ("WAP") slot machines in Arizona from the numerator of the Arizona sales factor.

Section 43-1132(A) provides that any taxpayer having income from business activity which is taxable both within and without this state shall allocate and apportion net income as provided in Title 43, Chapter 11, Article 4. A.R.S. § 43-1139 provides the apportionment formula comprised of the taxpayer's property, payroll and sales factors. At issue in this case is the sales factor. "The sales factor is a fraction, the numerator of which is the total sales of the taxpayer in this state during the tax period, and the denominator of which is the total sales of the taxpayer everywhere during the tax period. . . " A.R.S. § 43-1145. Sales of tangible personal property are considered to be made in this state if the property is delivered or shipped to a purchaser within this state. A.R.S. § 43-1146. Taxpayer and the Section agree that Taxpayer's WAP revenue is not from

the sale of tangible personal property and, therefore, is not sourced under A.R.S. § 43-1146. Rather, A.R.S. § 43-1147 applies. It states in part:

> [S]ales, other than sales of tangible personal property, are in this state if either of the following applies: (1) The income-producing activity is performed in this state. (2) The income-producing activity is performed both in and outside this state and a greater proportion of the income-producing activity is performed in this state than in any other state, based on costs of performance." A.R.S. § 43-1147(A).

Pursuant to A.A.C. R15-2D-806(1), "[t]he term "income-producing activity" applies to each separate item of income and means the transactions and activities directly engaged in by a taxpayer in the regular course of its trade or business for the ultimate purpose of obtaining gains or profit." Accordingly, "income-producing activity" includes, but is not limited to, the rental, leasing, licensing, or other use of tangible personal property. In this case, we must first identify the income-producing activity. Only then can we determine whether such income-producing activity occurs within the state or within and without the state.

As provided above, income-producing activity includes the rental, leasing, licensing, or other use of tangible personal property. The Section argues that Taxpayer's placement of WAP slot machines in Arizona casinos for use by Arizona players is a lease or other use of tangible personal property and the sales must be sourced to Arizona under A.A.C. R15-2D-806(3)(b)[1]. Alternatively, the Section argues that, regardless of the presence of the WAP slot machines in Arizona, Taxpayer's WAP revenue should be sourced to Arizona because the income-producing activity is performed wholly within Arizona.

Taxpayer, on the other hand, argues that the essence of its WAP agreement is providing a service to Arizona casinos and it is not a lease or rental agreement. Rather,

[1] A.A.C. R15-2D-806(3)(b) states that "[g]ross receipts from the rental, lease, or licensing of tangible personal property are in this state if the property is located in this state. The rental, lease, licensing, or other use of tangible personal property in this state is an income-producing activity separate from the rental, lease, licensing, or other use of the same property while located in another state."

A.A.C. R15-2D-806(1)(a) applies as the income-producing activity is the rendering of a personal service.[2] Therefore, as provided by A.A.C. R15-2D-806(3)(c), gross receipts for the performance of personal services are attributable to Arizona to the extent that the services are performed in Arizona. If services relating to a single item of income are performed partly within and partly without the state, the gross receipts are attributable to this state only if the greater proportion of the services is performed in this state, based on the costs of performance. In other words, if there is a determination that the Taxpayer is engaged in the rental or leasing of tangible personal property, the income-producing activity occurs wholly within Arizona and a cost of performance analysis is not necessary. A cost of performance analysis is only required when the income-producing activity occurs within and without the state. Taxpayer argues that whether its income-producing activities are defined narrowly or broadly, the vast majority of the cost of performance of its activities occur in [REDACTED]. Its WAP revenue is thus properly sourced to [REDACTED].

Rental or Lease of WAP Slot Machines

Section 42-5071 imposes Arizona's transaction privilege tax on persons engaged in the business of renting or leasing tangible personal property for a consideration. All leases of tangible personal property in Arizona are subject to tax under the personal property rental classification unless specifically deducted or excluded by statute. For reasons not relevant to this discussion, Taxpayer's gross income received from its WAP agreements is excluded from Arizona's transaction privilege tax. The question remains however whether the WAP agreements are a lease or rental for corporate tax purposes. Whether the Taxpayer terms the WAP agreement a lease or a service arrangement does not determine if it is the rental of tangible personal property.[3] Moreover, the

[2] A.A.C. R15-2D-806(1)(a) states that income-producing activity includes "[t]he rendering of personal services by employees or the use of tangible personal property by the taxpayer in performing a service."
[3] See *State Tax Comm'n v. Peck*, 106 Ariz. 394, 396 (1970). "Nor do we believe that the mere attachment of a label such as "license," borrowed from other areas of law, can be dispositive of the tax question before us."

payment terms, as a monthly fixed fee or percentage of the gross handle, are not determinative. Rather, the question is whether Arizona casinos obtain the requisite use and control of the WAP slot machines for the duration of the agreement so as to constitute a rental or lease.

In *City of Phoenix v. Bentley-Dille Gradall Rentals, Inc.*, the question was whether the Taxpayer was engaged in business under the personal property rental classification when it provided excavation machines with operators to various construction projects.[4] The Arizona Court of Appeals found that because the Taxpayer's employees had physical control of the equipment at all times at the customers' construction sites, and the Taxpayer determined the equipment to be provided and was responsible for correcting any mistakes by its operators, no possession or control was relinquished to the Taxpayer's customers so as to constitute rental activity. In this case, Taxpayer's employees do not have physical control of the WAP slot machines once installed in an Arizona casino. The casino and its customers use the WAP machines directly.

The Arizona Court of Appeals in *Energy Squared, Inc. v. Arizona Department of Revenue* found that customers lacked exclusive control over the tanning beds and booths at the taxpayer's tanning salon so as to constitute a rental because salon employees had control over access to the equipment, duration of use and appropriateness of use.[5] As noted above, Taxpayer's employees do not control access to the WAP slot machines or how they are used. The WAP slot machines are built to meet Arizona regulatory requirements, installed in Arizona casinos, and remain in the casinos for the duration of the agreement. The monitoring and administrative services cited by Taxpayer are merely in addition to the rental of tangible personal property and not a separate line of business from the rental.[6]

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[4] 136 Ariz. 289 (App. 1983).
[5] 203 Ariz. 507 (App. 2002)
[6] See *State Tax Commission of Arizona v. Holmes & Narver, Inc.*, 113 Ariz. 165 (1976).

Therefore, Taxpayer's customers obtain a level of use and control sufficient to constitute the rental of tangible personal property. The sales must be sourced to Arizona under A.A.C. R15-2D-806(3)(b). The Section correctly included revenue derived from Taxpayer's WAP slot machines in Arizona in the numerator of the Arizona sales factor.

Because the Section properly denied Taxpayer's refund request for tax years [REDACTED], it is not necessary to address whether adjustments for tax years [REDACTED] would reduce a claim for refund for those years.

Based on the foregoing, the Section's denial of Taxpayer's refund request for tax years [REDACTED] is upheld.

DATED this 11TH day of February, 2020.

ARIZONA DEPARTMENT OF REVENUE
HEARING OFFICE

[REDACTED]
Chief Hearing Officer

Original of the foregoing sent by
Certified mail to:

[REDACTED]

Copy of the foregoing delivered to:

Arizona Department of Revenue
Corporate Income Tax Audit Section