



Janice K. Brewer  
Governor

John A. Greene  
Director

## PRIVATE TAXPAYER RULING LR13-002

March 25, 2013

The Department issues this private taxpayer ruling in response to your letters of May 16, 2012 and August 29, 2012 (together, the "Request") requesting a ruling on behalf of . . . (the "Company"). Specifically, you request a ruling on the application of Arizona's transaction privilege tax ("TPT") to Company's computer backup and restoration business. Pursuant to A.R.S. § 42-2101, the Department may issue private taxpayer rulings to taxpayers and potential taxpayers on request.

### ISSUE:

Whether Company's gross receipts derived from its computer backup and restoration business is subject to Arizona's transaction privilege tax?

### RULING:

Based on the facts and documentation provided, the Department rules as follows:

Company is engaged in the business of renting tangible personal property in the form of prewritten software and is subject to transaction privilege tax under the personal property rental classification on its gross proceeds of sales or gross income derived from Arizona customers for its computer backup and restoration business.

Because Company's business is subject to tax under the personal property rental classification, the Department does not address whether Company's activities would fall within the scope of the job printing classification.

### FACTS PROVIDED BY COMPANY:

The following are facts excerpted from your May 16, 2012 letter:

The Company offers its customers online computer backup and restoration services. While the specific services provided depend on the subscription level chosen by the customer, in general these services involve the following:

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- automatic and continuous backup of customer computer files on remote servers maintained by the Company;
- duplication of customer computer files;
- secure transmission and storage of duplicated files via the internet to Company's data center;
- routine integrity checks on backed up files to ensure the stored version matches the current customer versions;
- access to stored files from remote locations not tied to a specific customer; and
- restoration of stored files.

These services are collectively referred to as the "Backup and Restore Service." The Backup and Restore Service operates continuously in the background on the customer's computer and transfers copies of revised customer files through an encrypted and secure connection using secure socket layer ("SSL") security technology to the Company's servers in their data centers. The Backup and Restore Service allows for unlimited customer support by e-mail, chat, and phone. The Company also offers a premium-level service where, in addition to the above, a customer can have a copy of their backed up files shipped to them on an external hard drive upon request and the backup service extends to the customer's hard drive (including external hard drives) so that programs and operating systems can be backed-up as well.

Customers initiate the Company's Backup and Restore Service via the Company's website by subscribing to the Backup and Restore Service and agreeing to pay a time-based subscription fee for the level of service desired. The subscription fee is not charged on a per transaction basis. At the time of subscription, the customer agrees to the Company's Terms of Service. The Terms of Service set forth the rights of both parties, the terms of the subscription to the Backup and Restore Services and rules governing the customer's conduct. Furthermore, the Terms of Service contain a license that the software agent (the "agent") loaded on the customer's computer is provided solely for the purpose of accessing the Backup and Restore Service and cannot be used or sublicensed for any other purpose.

At the time of subscription, [the agent] is downloaded onto the customer's computer and functions solely as a conduit to connect in a secure manner the customer's computer to the Company's remote technology platform and databases that serve to deliver the Backup and Restore Service. Additionally, the agent allows customers to access and restore remotely their backed up files through the Company's website. There is no separate charge for the agent and it is not separately stated on any invoice.

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The following are facts excerpted from the August 22, 2012 letter:

In regard to integrity checks, for all previously backed up files, the agent monitors the version of the file stored on the Company's hard drive to determine whether the customer has changed or edited the local version of the file. If the agent detects changes to the locally stored file, then the Company's service will replace the backup copy of the file with a current version of the file.

All subscription levels include duplication of customer computer files. The differences in subscription levels effect which files are automatically backed up [as well as] restore options. Taxpayer could not conduct its business in an identical manner without providing customer an agent. The technology architecture or service features, or both, would need to be changed to provide service without the use of the agent.

The following are facts excerpted from the "Terms of Service," which accompanied the August 22, 2012 letter:

### **TERMS OF SERVICE**

These Terms govern Your use of any service offerings or features provided by Company, including free services, the Company website, any Company downloadable client software which is provided solely for the purposes of accessing the services (a "Client"), and any updates and written documentation (together with the Client, the "Services"). Your continued use of the Services following modification to the Services or these Terms constitutes Your agreement to be bound by the modified Terms.

### **COMPANY PROPERTY**

You may be required to download a Client. The Client is licensed to You for the sole purpose of assessing the Services. The Services may automatically update the Client installed on Your computer, tablet, smartphone or any other electronic device (each, a "Device") when a new version is available. While You have an active Account, Company grants You a revocable, limited, non-transferable, non-exclusive license to access the Company website and use the Client and Services for Your personal or internal business purposes. You may use the Services only in accordance with the then-current documentation and customer support available at . . . or as specified in other documentation provided by Company or an authorized reseller. . . . Except for the limited license granted herein, You acknowledge that Company or third parties own all right, title, and interest in and to the Services, all copies thereof and all

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proprietary rights therein, including copyrights, patents, trademarks, logos, domain names or other brand features of Company.

### DISCUSSION & LEGAL ANALYSIS:

#### *A. Software is tangible personal property.*

For the purposes of Arizona's transaction privilege and use taxes, tangible personal property is much more than physical goods that a person can hold, touch, or feel. As defined in A.R.S. § 42-5001(16), it is property "which may be seen, weighed, measured, felt or touched or is in any other manner perceptible to the senses." Consistent with this broad definition, there is longstanding precedent in case law for applying this broad definition of tangible personal property to subjects other than physical goods, such as electricity, electronic delivery of software, and music played from a jukebox.<sup>1</sup> The Arizona Supreme Court's decision in *State v. Jones* addressed the scope of the taxation of tangible personal property.<sup>2</sup> In *State v. Jones*, the Arizona Supreme Court held when a person inserts a coin into a jukebox and listens to a phonograph record, he is purchasing tangible personal property.<sup>3</sup> The court stated, the playing of the record is perceptible to the sense of hearing and, hence, constitutes what the statute terms tangible personal property.<sup>4</sup> The current definition is not substantively different from that considered by the *Jones* court in 1943. Even the supreme court of another state, in a use tax opinion, noted the broad scope of Arizona's definition.<sup>5</sup>

Pursuant to the facts provided by Company, Company's gross proceeds of sales or gross income derived from its computer backup and restoration business include receipts for software. Similar to the broad definition of tangible personal property applied to the music heard in *Jones*, Arizona's expansive definition of tangible personal property includes software because software is property that may be seen, weighed, measured, felt or touched or is in any other manner perceptible to the senses. Therefore, Company's gross proceeds of sales or gross income include receipts from tangible personal property.

#### *B. Company engages in the business of renting tangible personal property.*

A determination must be made as to whether the gross proceeds of sales derived from a transaction that involves computer software, including remote access software arrangements, are properly classified under the retail classification at A.R.S. § 42-5061, the personal property rental classification at A.R.S. § 42-5071, or are otherwise exempt from

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<sup>1</sup> *State Tax Comm'n v. Marcus J. Lawrence Mem. Hosp.*, 108 Ariz. 198, 495 P.2d 129 (1972) (en banc); *State v. Jones*, 60 Ariz. 412, 137 P.2d 970 (1943).

<sup>2</sup> *Jones*, 60 Ariz. at 415, 137 P.2d at 971.

<sup>3</sup> *Id.*, 60 Ariz. at 415, 137 P.2d at 971.

<sup>4</sup> *Id.*

<sup>5</sup> *Ramco, Inc. v. Director*, 248 N.W.2d 122, 124 (Iowa 1976).

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Arizona TPT. The tax base for the retail classification is limited to the gross receipts derived from the business of selling tangible personal property “at retail.”<sup>6</sup> However, the gross receipts from the rental or leasing of tangible personal property are subject to TPT under A.R.S. § 42-5071, unless a specific exemption applies.<sup>7</sup>

To determine whether a taxpayer is engaged in “selling,” “leasing,” or “renting” tangible personal property in the form of computer software, the Department first examines the relationship between the gross receipts derived from the transaction and the role of the software in the transaction as a whole. A transaction in which a taxpayer derives receipts from offering computer based services with software and where the receipts are related to the software are generally subject to TPT. Next, the Department reviews the rights that a taxpayer provides to its customer under the precise terms of the contractual agreement for the transaction at issue to determine the duration of the customer's access to the underlying software and whether a company cedes the requisite amount of use and possession so as to establish that it is renting tangible personal property.

A software license is dissimilar to arrangements that fall under the general “license” nomenclature used for leases and rentals of physical tangible personal property (e.g., property that can be touched or felt). As discussed, virtually all sales of prewritten software are sales of nonexclusive rights to use, regardless of whether they are sold on physical media or transmitted electronically or whether they have perpetual or limited terms.<sup>8</sup> Because of the interplay of federal copyright laws and the differences in the meaning of the terms “sale” and “license” as used in the federal Copyright Act,<sup>9</sup> compared to common law applications used in Arizona tax law cases,<sup>10</sup> a software license should not be confused with the common law concept of license. Tax treatment is based upon the rights that arise from a particular contractual arrangement.

A business is subject to TPT under the retail classification if the taxpayer grants a customer the right to the underlying product for a perpetual duration. A business is subject to TPT under the personal property rental classification if the contractual agreement has the effect of providing a customer, for consideration, with the defined and exclusive right of use of the software for a specified period, the termination or conclusion of which necessitates the customer's return of the software to the vendor. In regards to use, software manipulation constitutes use of the software. For possession, constructive possession may be

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<sup>6</sup> A.R.S. § 42-5061(A).

<sup>7</sup> A.R.S. § 42-5071; A.A.C. R15-5-154(B).

<sup>8</sup> Frederick Chong & Gianpaolo Carraro, *Building Distributed Applications: Architecture Strategies for Catching the Long Tail*, MICROSOFT DEVELOPER NETWORK, Apr. 2006, <http://msdn.microsoft.com>; H. WARD CLASSEN, *SOFTWARE LICENSING FOR LICENSEES AND LICENSORS* 199-200 (3d ed. 2009).

<sup>9</sup> 17 U.S.C. § 101 et seq.

<sup>10</sup> See, e.g., CLASSEN, *supra* note 11, at 19.

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established through either the transfer of a software license or a level of use and manipulation that establishes the user's possession of the software.

If the transaction is classified under A.R.S. § 42-5071, A.A.C. R15-5-1502(A) provides, “the gross income derived from the rental of tangible personal property is included in the tax base under the personal property rental classification unless a specific statutory exemption, exclusion, or deduction applies.” While there is a specific exemption for professional or personal service occupations or businesses as well as one for services rendered in addition to retail sales of tangible personal property under the retail classification, no corollaries exist for the personal property rental classification. A.A.C. R15-5-1502(D) enunciates this principle by stating, “[g]ross income from the rental of tangible personal property includes charges for installation, labor, insurance, maintenance, repairs, pick-up, delivery, assembly, set-up, personal property taxes, and penalty fees even if these charges are billed as separate items, unless a specific statutory exemption, exclusion, or deduction applies.”

Company engages in the business of renting tangible personal property in the form of computer software based on the customer's limited duration of access to the software and the ceding of requisite use and control through the transfer of a software license from Company to the customer.

*C. Arizona TPT applies to all gross receipts collected from customers located in Arizona.*

Company has a physical presence in the State of Arizona and is taxable on all rentals of tangible personal property to Arizona customers. A.A.C. R-15-5-1503(D) states:

Gross receipts from leasing or renting tangible personal property are not taxable if the property is shipped or delivered outside of the state and intended, at the inception of the lease, for use exclusively outside of the state.

The burden of proof for establishing the applicability of subsection (D) is on the lessor.<sup>11</sup>

For remote access software arrangements, the server location where the software and files are “physically” stored makes no difference for state TPT purposes; the location where the lessee uses the leased property on a non-temporary basis is what is determinative because the gross receipts from leasing or renting tangible personal property are not taxable pursuant to A.A.C. R15-5-1503(D) if the property is shipped or delivered outside the state and intended, at the inception of the lease, for use exclusively outside of the state. Therefore, a taxpayer’s gross receipts derived from software leased to out-of-state lessees who use the software exclusively outside the state would be deductible.

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<sup>11</sup> A.A.C. R15-5-1503(F).

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**This response is a private taxpayer ruling and the determinations herein are based solely on the facts provided in the Request. Therefore, the conclusions in this private taxpayer ruling do not extend beyond the facts presented in your correspondence dated May 16, 2012 and August 22, 2012. The determinations are subject to change should the facts prove to be different on audit. If it is determined that undisclosed facts were substantial or material to the department's making of an accurate determination, this private taxpayer ruling shall be null and void. Further, the determination is subject to future change depending on changes in statutes, administrative rules, case law or notification of a different department position.**

**The determinations in this private taxpayer ruling are only applicable to the taxpayer requesting the ruling and may not be relied upon, cited nor introduced into evidence in any proceeding by a taxpayer other than the taxpayer who has received the private taxpayer ruling. In addition, this private taxpayer ruling only applies to transactions that occur or tax liabilities that accrue from and after the date the taxpayer receives the ruling.**

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