ARIZONA TRANSACTION PRIVILEGE TAX RULING
TPR 21-2

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ISSUE:

Whether providing remotely accessed web hosting and servers is taxable as a rental of tangible personal property under Arizona Revised Statutes (A.R.S.) § 42-5071 and Model City Tax Code (MCTC) § -450.

APPLICABLE LAW:

A.R.S. § 42-5071 imposes the transaction privilege tax (TPT) on the business of leasing or renting tangible personal property for a consideration. The tax base for the personal property rental classification is the gross proceeds of sales or gross income derived from the business. All leases are taxable unless a specific statutory deduction or exclusion applies. MCTC § -450 imposes city privilege tax similar to state provisions, however, city privilege tax is also expressly imposed on the business of licensing for use of tangible personal property. MCTC § -100 defines a license for use as "any agreement between the user ("licensee") and the owner or the owner's agent ("licensor") for the use of the licensor's property whereby the licensor receives consideration, where such agreement does not qualify as a "sale" or "lease" or "rental" agreement."

Arizona Administrative Code (A.A.C.) R15-5-1503(D) provides that 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.

A.A.C. R15-5-1502(D) provides that services provided in addition to a rental of tangible personal property are taxable by the state and county under the personal property rental classification; unless found to be a nontaxable separate line of business. Conversely, MCTC § -450(c)(6) provides an exemption for separately stated direct customer services as defined in MCTC Reg. § -100.2.

The Arizona Supreme Court established guidelines for determining whether a particular activity is taxable by the state and county as personal property rental.[1] It resolved the question of whether the facts presented before it constituted a rental by looking at the dictionary definition of the word rent which meant "(1) to take and hold under an agreement to pay rent," or "(2) to obtain the possession and use of a place or article for rent.[2]

The court determined that:

[1] *State Tax Commission v. Peck*, 106 Ariz. 394 (1970).
[2] *Id*. at 396.

> When customers use the equipment on the premises of the plaintiffs… such customers have an exclusive use of the equipment for a fixed period of time and for payment of a fixed amount of money… 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.
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> We do not believe that the terms 'leasing' or 'renting' as used in the statute require that that property so leased or rented be physically capable of being transported from one place to another by the customer. 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.[3]

As may be gathered from *Peck*, actual possession of the property by its transfer to the customer off the vendor's premises is not essential for a finding of exclusive use and control or to find a taxable rental. Furthermore, control may be found through exclusive use of property that remains on the vendor's premises. The vendor's ability to prevent or interrupt use of the machine; or the dependence of the customer on vendor-supplied utilities did not prevent there being a taxable rental in *Peck*.[4]

DISCUSSION AND RULING:

Advancements in remote networking technology have created a large industry offering various remote hosting, server, and data storage options based on customers' needs.[5] This is a unique industry because server hardware may be located anywhere in the world and accessed by customers anywhere in the world. As a result, guidance is required to assist a business in determining if they are subject to Arizona's TPT when providing remote hosting, servers, and data storage. In computing the term "server" may have more than one meaning, however, this ruling deals with a server as it is commonly understood to be a physical piece of hardware, provided with an operating system, and accessed from a remote location.[6] Applications software, whether provided by the same vendor or an independent vendor are not addressed in this guidance.

The technology required to access remotely located server hardware and software has seen a rapid acceleration in development over the last few decades. Notwithstanding these technological developments, the majority of Arizona's rules and case law relied upon today—

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[3] *Id.*

[4] *Id.*

[5] The global server market is expected to be worth 143.31 billion USD by 2028. See, https://www.prnewswire.com/news-releases/server-market-size-worth-145-31-billion-by-2028--cagr-7-8-grand-view-research-inc-301272206.html[5] David M. Peterson, TCP/IP Networking 79 (Jerry Papke et al. eds., 1995).

[6] Servers, both as hardware and software, are designed to passively wait for incoming client requests (*e.g.,* a website or an application) and then "serve" the client with the requested service or information. Servers perform many functions including: hosting software applications and websites, sharing files and folders, or sending and receiving email.

pertaining to taxable rentals of tangible personal property—emerged over forty years ago. As a result, some taxpayers have not clearly understood that the existing TPT statutes can apply to businesses using new technologies; and have not understood that providing access to remotely stored server hardware is a taxable rental under existing statutes and cases. These questions primarily involve applying state and county TPT, but some taxpayers have even disputed the applicability of MCTC § -450 that expressly imposes city privilege tax on the business of licensing for use of tangible personal property (where such is not a lease or rental).

A person is engaged in business under the personal property rental classification when they lease or rent tangible personal property for a consideration.[7] 'Lease' is defined as "a contract by which one conveys . . . equipment . . . for a specified term and for a specified rent."[8] 'Rent' is defined as making something "available for use or service in return for payment."[9] Tangible personal property is broadly defined in A.R.S. § 42-5001(21) and MCTC § -100 to include anything "which may be seen, weighed, measured, felt or touched or is in any other manner perceptible to the senses."[10] Nevertheless, *State Tax Commission v. Peck*, 106 Ariz. 394, 396 (1970) ruled that a rental of tangible personal property is subject to TPT when the customer has exclusive control over the manual operations necessary to run the tangible personal property—regardless of whether the owner retains some power over the machine, or its use remains dependent on owner-supplied utilities and an owner-supplied facility housing the machine.

Thus, in order to determine if various types of online hosting, servers, and data storage are taxable, first it must be determined if the customer has exclusive use and control over the manual operations of the web hosting, server or stored data, for a period of time, and for a fixed payment.

<u>Common types of remote hosting include dedicated servers, virtual private servers, or shared hosting.</u>

Dedicated Servers: A dedicated server generally refers to a physical server which is wholly dedicated by the provider to a single customer's use. A dedicated server may be fully self-managed by the customer, or the customer may contract with the provider to manage certain aspects of the server (*e.g.,* setup, installing upgrades, installing applications, applying patches, etc.). The customer provisions the operating system, or if managed, the provider will provision the operating system of the customer's choice. Whether self-managed or provider-managed, a customer will have exclusive control over the manual operations of the physical server's operating system, computing power, memory, and any other resources which are not time shared between users.

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[7] A.R.S. § 42-5071(A); MCTC § -450(a).
[8] *Lease*, *Merriam-Webster Dictionary*, https://www.merriam-webster.com/dictionary/lease.
[9] *Rent, Merriam-Webster Dictionary*, https://www.merriam-webster.com/dictionary/rent.
[10] Court rulings have further strengthened the definition of tangible personal property. See *State Tax Comm'n v. Marcus J. Lawrence Mem'l Hosp.,* 60 Ariz. 198 (1972) (finding that electricity is tangible personal property); *State v. Jones*, 60 Ariz. 412 (1943) (sounds perceptible to the senses are tangible personal property); *ADP, LLC v. Arizona Dept. of Revenue*, No. 926, TX2018-000246, at 5 (Ariz. Tax Ct. July 2, 2021) (ruling where software code is perceptible to the senses it is tangible personal property.

Virtual Private Server: A virtual private server (referred to as a VPS) is a physical server whose resources are shared with a number of customers. However, the virtual private server operates in such a way that from the customer's perspective the control and functionality for a virtual private server are the same, and are otherwise indistinguishable, from a dedicated server (*i.e.,* processing, and short or long term storage are wholly dedicated and not shared). Each virtual private server on the physical server operates in its own isolated environment. Similar to a dedicated server, a virtual private server may be fully managed by the customer, or it may be managed by the provider (*e.g.,* setup, installing upgrades, installing applications, applying patches, etc.). Whether self, or provider managed, a virtual private server customer has administration (root) access to the imaged operating system and through this operating system the customer is allowed full control over installation of software applications and the manual operations of their allocated server resources and disk storage space.[11]

Web Hosting: Web hosting, as its name implies, is generally dedicated to hosting website domains on a server, using the Domain Name System (DNS) to provide a unique address to each hosted domain. Data containing a website's structure is placed on a server by the customer.[12] This data is partitioned and accessible only to that web hosting customer or those the customer authorizes and allows to access them. When in use, the customer has exclusive control over their assigned server resources. For example, uploading their data (*i.e.,* the website's content) on the web hosting server within their allocated storage space requires use of the server's resources;[13] or when accessing their data.[14] Based on the provider's plan, a customer can host one or multiple websites with one web hosting account.

Each web hosting customer, through their unique login identifier and password, is provided access to a directory through an online control panel (or some other software application). This login allows each customer control over their stored files,[15] settings, web applications, domain settings, metrics, security, and any included software (*e.g.,* email). That is to say, the customer is granted exclusive use and control over the web hosting's manual controls, the legally allowed[16] content

[11] A virtual private server customer will not have access to the underlying operating system which manages and operates each virtual instance; however, the virtual private server customer is not leasing the underlying system, they are leasing the virtual image, which they do control.

[12] Examples of data files uploaded to a web hosting server include html, CSS, JavaScript, text, image, and video files.

[13] Usually by means of a control panel application provided by the web hosting provider or some other third party file transfer protocol software.

[14] Although the web hosting client has exclusive control over uploading data, a provider will likely contractually limit the types of content allowed on their servers (*e.g.,* no illegal content, viruses, etc.). However, such limitations tend to be universal with any lessor of tangible personal property. For example, the lessor of a chain saw may limit its use to wood or a laundromat may prohibit customers from washing oily rags in their machines. Such limitations are generally contractual and do not limit the customer from exercising the control requisite for a taxable rental.

[15] A hosting plan may provide alternative modes of storage. The hosting provider may allocate and reserve a specific amount of space for a customer, or the amount of storage is predetermined but it is only assigned and allocated as it is used and when the data is removed that space may be reallocated for another customer's use.

[16] The terms of use may restrict what content may be placed on a website hosted by a particular provider.

of its website; and in using the provisioned resources, exercises exclusive possession of and control of resources during the time of use. Furthermore, the customer is paying for a certain amount of the server's physical resources, such as computing power, short-term memory and long-term memory, and when those physical resources are used, they are used exclusively by that customer.

Dedicated Servers, Virtual Private Servers, and Web Hosting are Taxable Rentals

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. Dedicated servers and virtual private servers are tangible personal property, as defined by Arizona's statutes and case law; and without an operating system, whether self or provider managed, are unusable to the customer. 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. A web hosting customer pays for a specified portion of the server's physical resources (data storage, computing power, etc.), and software which allows them to manage uploading, downloading, and moving data files (*e.g.,* html and text files) on an on-demand basis, as needed. The customer's specified portion of the server and the software used to manage the web hosting are items of tangible personal property where manual operations are controlled by the customer.

Thus assuming nexus,[17] a server rental (including dedicated servers, virtual private server and dedicated virtual or physical servers) is taxable under the personal property rental classification when:

1. The server is intended to be used by an Arizona located lessee;
2. Lessee is provided exclusive use and control of the server, or server features, for a fixed payment; [18]
3. The agreement, if not renewed, terminates at:
    a. A specific time (*e.g.,* subscription agreements); or
    b. Upon a specific event (*e.g.,* termination notice or nonpayment); and
4. After termination the lessee no longer has access to the server.

Although not a topic of this ruling, it should be noted that bundling of taxable and non-taxable revenues may result in both being taxable; and those revenues generated from a nontaxable

[17] *S. Dakota v. Wayfair, Inc*., 138 S. Ct. 2080, 2085, 201 L. Ed. 2d 403 (2018), ruled that a taxing authority cannot impose a tax unless the taxpayer has substantial nexus with the state. A.A.C. R15-5-2002 provides examples of those activities which create a substantial nexus with Arizona. A person engaged in the business of renting tangible personal property, and who has substantial nexus with Arizona, is presumed taxable on the gross income derived from a taxable business activity occurring in Arizona. See *Arizona State Tax Comm'n v. Garrett Corp*., 79 Ariz. 389, 393 (1955) (holding that the legal incidence of TPT is on the person engaged in the taxable business activity and not upon the transaction itself).

[18] 'Full use and control of the server refers to the server features, such as the directory, or operating system, etc., and does not mean the lessee must have full use and control over the physical server.

activity which are incidental to the taxable business, may also be taxable.[19] These principles may apply to businesses offering website hosting and other separate nontaxable business activities. As well, separately stated services, such as delivery, installation, repair, maintenance, or other services which qualify as "direct customer services" are deductible for city privilege tax purposes.[20]

Robert Woods, Director

Signed: , 2021

Explanatory Notice
The purpose of a tax ruling is to provide interpretive guidance to the general public and to department personnel. A tax ruling is intended to encompass issues of law that are not adequately covered in statute, case law or administrative rules. A tax ruling is a position statement that provides interpretation, detail, or supplementary information concerning application of the law. Relevant statute, case law, or administrative rules, as well as a subsequent ruling, may modify or negate any or all of the provisions of any tax ruling. See GTP 96-1 for more detailed information regarding documents issued by the Department of Revenue.

[19] See *State Tax Comm'n v. Holmes & Narver, Inc.*, 113 Ariz. 165 (1976) (finding that a person engaged in a taxable business may have a separate nontaxable line of business if: (1) it can be readily ascertained without substantial difficulty which portion of the business is for non-taxable professional or personal services; (2) the income related to the nontaxable line of business is not inconsequential; and (3) the professional or personal services are not incidental to the taxable business); *City of Phoenix v. Arizona Rent-A-Car Systems, Inc.*, 182 Ariz. 75 (Ct. App. 1995) (applying the *Holmes & Narver* separate line of business test to a car rental business and finding that "integral" is synonymous with "inconsequential); *Walden Books Co. v. Dep't of Revenue*, 198 Ariz. 584 (Ct. App. 2000) (finding that services bundled with taxable sales will be taxable).
[20] See MCTC -450(c)(6); see also MCTC Reg. -100.2 for a definition of "direct customer services".