

## **Arizona's Tortured Method of Imposing Sales Tax on Services**

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In this edition of SALT From my Saddle, Busby identifies two key differences between the tax base for Arizona's sales tax on retail sales and its sales tax on rentals of tangible personal property. He explains how Arizona taxing authorities have acted on these differences to impose sales tax on the gross receipts of many service businesses — including ones most people would not consider to be in the business of renting tangible personal property.

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Most states do not impose broad sales taxes on services. Likewise, Arizona's Legislature only specifically identified a handful of services, such as telecommunications services,<sup>1</sup> pipeline operations,<sup>2</sup> and some construction contracting services,<sup>3</sup> that should be subject to Arizona sales tax.

<sup>1</sup>A.R.S. section 42-5064.

<sup>2</sup>A.R.S. section 42-5067.

<sup>3</sup>A.R.S. section 42-5075; and see Busby, "Taxing Contractors Under Arizona's Sales Tax Reform Laws," *State Tax Notes*, June 1, 2015, p. 673.

However, partly because of two key differences between Arizona's sales tax on retail sales and its sales tax on rentals of tangible personal property, many service businesses have been surprised to find that the Department of Revenue says their gross receipts are subject to the state's sales tax on rentals of tangible personal property.

### The Taxation of Services Rendered in Addition to Selling vs. Renting Tangible Personal Property

The Legislature clearly excluded services rendered in addition to selling tangible personal property at retail from the scope of Arizona's tax on retail sales.<sup>4</sup> Unfortunately, it did not specify a corresponding exclusion for proceeds from renting tangible personal property.

To its credit, in one of its rules, the DOR put persons engaged in the business of renting tangible personal property on notice that they may be subject to tax on a variety of services, including "installation, labor, insurance, maintenance, repairs, pick-up, delivery, assembly, set-up, personal property taxes, and penalty fees even if those charges are billed as separate items, unless a specific statutory exemption, exclusion, or deduction applies."<sup>5</sup>

### The Taxation of Inconsequential Transfers of Tangible Personal Property

While there is an exclusion from Arizona's sales tax on persons engaged in the business of selling tangible personal property for "professional or personal service occupations or businesses that involve transfers of tangible personal property only as inconsequential

<sup>4</sup>A.R.S. section 42-5061(A)(2).

<sup>5</sup>A.A.C. R15-5-1502(D).

elements,”<sup>6</sup> there is not a specific, comparable statutory exclusion from Arizona’s sales tax on persons engaged in the business of renting tangible personal property.

Worse yet, even though the DOR never issued an administrative rule or transaction privilege tax ruling to alert otherwise nontaxable service businesses that their gross receipts may be subject to Arizona’s sales tax on proceeds from renting tangible personal property if *any* portion of their business involves letting their customers use something the DOR considers tangible personal property, the DOR is now taking that position.

For example, the DOR’s director has ruled that companies that provide their customers with online access to a database containing articles and notes that their research analysts wrote are subject to Arizona’s sales tax on rentals of tangible personal property.<sup>7</sup> Likewise, the DOR issued private taxpayer rulings indicating that online computer backup service businesses and cloud storage businesses are subject to Arizona’s sales tax on rentals of tangible personal property.<sup>8</sup> The DOR even ruled that a company that permitted its customers to use its online “software tools” to create websites that the company hosted was subject to Arizona’s sales tax as if it had rented tangible personal property to them.<sup>9</sup>

### The DOR’s Expansive View of Tangible Personal Property

Like many other states, Arizona defines tangible personal property as “personal property which may be seen, weighed, measured, felt or touched or is in any other manner perceptible to the senses.”<sup>10</sup> Despite the definition’s emphasis on things that are perceptible to human senses, the DOR applies an extremely broad interpretation that encompasses many forms of intellectual property that most people would not ordinarily consider as tangible personal property.

As a result, service businesses often are surprised not only by the key statutory differences described above, but also to learn that the DOR believes that their business involves rentals of tangible personal property in the first place — such as the online research database, online computer backup, cloud storage, and online website building and hosting businesses referred to above. ■

<sup>6</sup>A.R.S. section 42-5061(A)(1).

<sup>7</sup>Director’s decision in Case No. 201400197-S.

<sup>8</sup>Arizona Private Taxpayer Ruling LR13-002 and Notice of Modification to Arizona Private Taxpayer Ruling LR13-006, respectively.

<sup>9</sup>Arizona Taxpayer Information Ruling LR15-005.

<sup>10</sup>A.R.S. section 42-5001(17).