



This Week in State Tax (TWIST)

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Arizona: Application Software Taxable as Tangible Personal Property

The Arizona Court of Appeals recently upheld a superior court's order that a taxpayer was renting software subject to the state's Transaction Privilege Tax (TPT). Since 2007, the taxpayer had licensed its Enterprise eTime application software to Maricopa County. The software allowed County employees to login to the Internet from their computers and enter their time and other employment data. The taxpayer requested a refund of the state and City of Phoenix TPT collected on the monthly revenues from its contract with the County. After the TPT refund was denied and a trial court ruled in favor of the Department of Revenue and the City, the taxpayer appealed.

Under Arizona law, TPT applies to any lease or rental of tangible personal property. Tangible personal property in turn, is broadly defined as "personal property that may be seen, weighed, measured, felt or touched or that is in any other manner perceptible to the senses." On appeal, the taxpayer argued that the software was intangible personal property that was not subject to TPT. The court, relying on the Arizona Supreme Court's 1943 decision in *State v. Jones*, disagreed. In *Jones*, the court held that the placing of a coin in a slot to play a record was the sale of tangible personal property subject to TPT because the music was perceptible to the senses. Similarly, the court concluded that the software at issue was "perceptible" to users who were able to view the program when it was accessed. The taxpayer argued that *Jones* was archaic, wrongly decided, and should not be followed. The court again rejected this assertion. Despite the significant technological advances that had transpired since the *Jones* decision, the definition of tangible personal property remained essentially the same and, in the Court's view, *Jones* remained binding and relevant. As such, the Court concluded that the software at issue was tangible personal property.

The Court next addressed the taxpayer's argument that it was not leasing the software but was providing human resources services. Under prior Arizona cases addressing the distinction between providing a service and renting property, the courts have held that the "use and control" exercised over the property is evidence as to whether a lease or rental of tangible personal property is occurring. Here, the County's use and control over the software established that it was renting the software from the taxpayer. The taxpayer also argued that imposing TPT on its charges violated the Internet Tax Freedom Act because pre-Internet, its services were not taxable. The Court disagreed. In its view, the taxpayer was renting software that automated tasks previously done by human employees. The change in taxation reflected the fact that the taxpayer had automated its services and did not, in the Court's view, constitute a discriminatory tax on electronic commerce.

Finally, the Court concluded that the software was also subject to the TPT under the Phoenix City Code. Computer software, other than custom software, was expressly included in the City's definition of tangible personal property. The Court determined that the eTime software, despite being modified for the County, was not custom software as the modifications were separately accounted for in the taxpayer's agreement with the County. Please contact [Stacey Matthew](#) with questions on *ADP, LLP v. ADOR and City of Phoenix*.



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