Arizona Is Reexamining the Taxation Of Digital Goods and Services

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In this edition of SALT From My Saddle, Busby explains why an Arizona legislative committee is reexamining the application of state and local sales taxes to proceeds from digital goods and services, the scope of its review, and where the panel seems to be leaning after its first meeting.

Arizona's Joint Legislative Ad Hoc Study Committee on the Tax Treatment of Digital Goods and Services had its first meeting on July 31. It plans to meet each month until the next legislative session begins in January and is likely to recommend legislation to clarify whether digital goods and services are subject to sales tax.

The Need for Transparency

The committee was formed at the request of the business community, which is concerned by aggressive positions that the Department of Revenue has quietly advanced in audits and in private taxpayer rulings based on sales tax laws enacted long before digital goods and services were even contemplated.

For instance, given the DOR's expansive view of Arizona's definition of tangible personal property and of what constitutes a lease, it has held that proceeds from online research databases, online computer backup services, cloud storage services, and online website building and hosting businesses are subject to sales tax as proceeds from renting tangible personal property.[1]

Likewise, given its expansive definition of tangible personal property, the DOR believes that many companies worldwide receiving income from digital goods licensed to customers with billing addresses in Arizona are subject to both state and municipal sales taxes even though the companies do not have a physical presence in the state.[2]

According to a legislative staffer's presentation, Arizona is one of nine states that impose tax on digital goods based merely on its revenue agency's interpretation of the law. By contrast, 17 states opt not to tax digital goods based on their interpretations of the law, 18 impose tax on digital goods via statute, and two have statutes that exempt digital goods.[3]

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[1] Busby, "Arizona's Tortured Method of Imposing Sales Tax on Services," *State Tax Notes*, Mar. 20, 2017, p. 1031.

[2] Busby, "Arizona's New State and Local Sales Tax Nexus Guidelines," *State Tax Notes*, Dec. 12, 2016, p. 841.

[3] Arizona State Legislature Ad Hoc Joint Committee on the Tax Treatment of Digital Goods and Services, "Tax Treatment of Digital Goods and Services: Overview and Cross-State Comparison" (July 31, 2017).

The Committee's Charge

The committee is expected to review:
- the DOR's positions and its efforts to disseminate those positions;
- legal issues regarding the taxation of digital goods and services in Arizona and other states;
- the administrative implications of taxing digital goods and services, including the impact on both taxpayer compliance and tax administration;
- the tax treatment of digital goods and services in other states, including the economic impact;
- the potential Arizona tax impact of taxing digital goods and services; and
- recent legislative and regulatory actions designed to address the tax treatment of digital goods and services in Arizona and other states.[4]

Initial Leanings

During the committee's first meeting, Rep. Michelle Ugenti-Rita (R), its co-chair, interrupted a legislative staffer during his overview presentation to clarify that while some states have responded to the advent of digital goods and services by expanding their tax bases to specifically tax such goods and services, Arizona may not go in that direction. That was consistent with her statement upon the committee's formation that "as people's behavior changes with advancements in technology, government too must not hinder technological innovations or growth in our economy."[5]

Before the first meeting, the committee's other co-chair, Sen. David Farnsworth (R), said that it "is designed to examine Arizona's tax structure to assure it is keeping pace with the rapid development and expansion of digital technologies, while at the same time guaranteeing that Arizona retains its competitive business climate."[6]

During the committee's initial meeting:
- Both co-chairs inquired about the state's potential exposure for refund claims if one or more taxpayers successfully challenge the DOR's positions in this area.
- DOR deputy director and committee member Grant Nülle argued that an exemption for digital goods and services could have a substantial fiscal impact.[7]
- Arizona Tax Research Association President Kevin McCarthy, a committee member, questioned whether an exemption that merely clarifies that digital goods and services never should have been taxed in the first place should be considered to have a fiscal impact.

After the committee's first meeting, the only certainty is that this issue is likely to keep many lobbyists busy during the next legislative session. ∎

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[4] Arizona House of Representatives and Arizona Senate news release, "House and Senate Announce Creation of Ad Hoc Study Committee on the Tax Treatment of Digital Goods and Services" (June 8, 2017).

[5] *Id.*

[6] *Id.*

[7] Grant Nülle, "Taxability of Digital Goods, Software and other Electronic Items in Arizona" (July 31, 2017).