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In this edition of SALT From My Saddle, Busby explains how and why the Arizona Legislature left providers of digital goods and services in a difficult situation, the quandary they face, and the action they may have to take to achieve certainty.

The author helped draft H.B. 2479.

For the first half of this year's legislative session, the Arizona Legislature seemed poised to clarify which digital goods and services are taxable in the state.

The Proposed Legislation

Essentially, H.B. 2479[1] would have:

- defined prewritten computer software and permitted the Department of Revenue and the cities to impose retail sales taxes on proceeds from prewritten computer software regardless of delivery method;
- defined specified digital goods to include digital audio-visual works, digital audio works, and digital books, and permitted the DOR and the cities to impose retail sales taxes on proceeds from such items when they are transferred in whole to a customer, but prohibited the DOR and the cities from taxing them when they are merely streamed and not transferred to the customer;
- defined and prohibited the DOR and the cities from imposing tax on proceeds from specified digital services, including software as a service, platform as a service, infrastructure as a service, application service providers, hosting services, data storage management, data processing and information services, steaming services, digital authentication services, and any other cloud-based or other remotely accessed computing services.

However, our lawmakers did not finish what they started. After studying these issues all summer and grandstanding regarding the gravity of the problem caused by the lack of legislation to address the taxation of the digital economy, they shirked their responsibility. Thus, in 2018 Arizona's sales and use tax statutes still do not even specify whether software is taxable,[2] much less define digital goods and services and specify whether any or all of them are taxable.

Therefore, unless taxpayers and tax professionals familiarize themselves with the

[1]For more details regarding the proposed legislation, see Busby, "Arizona Intends to Clarify Taxation of Digital Goods and Services," *State Tax Notes*, Feb. 19, 2018, p. 711; and H.B. 2479.

[2]In 1993 the DOR promulgated an administrative rule in which it asserted that proceeds from prewritten software are taxable as sales of tangible personal property but, to date, Arizona's Legislature has not defined software as tangible personal property or modified the state's statutes to clarify that software is taxable for some other reason like most states did by the 1990s.

DOR's mysterious audit positions and private taxpayer rulings, even those who carefully peruse Arizona's statutes would have no way of knowing that the DOR believes a wide variety of digital goods and services are taxable.[3]

Why the Legislation Failed

H.B. 2479 quickly passed through the House by a comfortable margin early in the legislative session. The following day, less than an hour before the Senate was scheduled to vote on its version of the bill, the Joint Legislative Budget Committee (JLBC) released a fiscal note. In it the JLBC predicted that the bill would have a negative fiscal impact, but indicated that it was unable to quantify the loss. Then, without questioning its assumptions and figures, or giving proponents a chance to respond, the JLBC indicated that an advocacy organization that was opposed to the bill estimated that it would cost the state $78 million per year.[4]

The fiscal note scared enough lawmakers that Senate leadership postponed the vote on the bill in the Senate. Proponents later discredited the opponent's assumptions and figures and the JLBC eventually published a memorandum acknowledging that the opponent overstated the likely revenue loss.[5]

But then, for the last six days of the legislative session, Arizona teachers went on strike in pursuit of a 20 percent pay raise. By the time 50,000 teachers marched on the state capital for six days (in this election year) and the Legislature capitulated to their demands, several lawmakers who previously planned on voting for H.B. 2479 concluded that they no longer could vote for a bill that allegedly would cost the state money, even though proponents of the bill believe that any money the state collected on digital goods and services was not lawfully collected in the first place.

The Quandary

By not specifying whether digital goods and services are subject to tax in Arizona, the Legislature left providers in a damned-if-you-do, damned-if-you-don't position. That is, to the extent they choose to collect tax on their proceeds from providing digital goods and services to Arizona customers without specific statutory authority to do so, they expose themselves to potential class action lawsuits for allegedly collecting more tax than is lawfully due. Yet if they do not collect tax from their Arizona customers and the DOR determines that they should have paid tax, they may have to pay tax that they did not collect from their customers, along with penalties and interest, if audited.

The Path to Certainty

Because the Legislature failed to specify which digital goods and services, if any, are subject to tax, providers' potential exposure (whether for class action lawsuits or audit assessments) will only increase until they get the courts to decide whether the DOR can lawfully collect tax on proceeds from digital goods and services as if they were sales or rentals of tangible personal property under Arizona's outdated tax statutes.

Rather than give in on tax assessments for proceeds from providing digital goods or services, taxpayers should aggressively fight such assessments — especially because Arizona recently increased the amount of attorney fees taxpayers can recover when they prevail in such suits,[6] and because this year the Legislature authorized taxpayers to skip the administrative appeals process in order to resolve their cases more expeditiously by going straight to court instead, if they like.[7]

Similarly, providers of digital goods and services who began collecting tax from their Arizona customers, even though the state's statutes do not specify that their services are

[3] For more information about some of the services the DOR believes are taxable and why it believes they are taxable, see Busby, "Arizona's Tortured Method of Imposing Sales Tax on Services," *State Tax Notes*, Mar. 20, 2017, p. 1031.

[4] Joint Legislative Budget Committee Fiscal Note (Mar. 1, 2018).

[5] JLBC Staff Memorandum (Apr. 6, 2018).

[6] *See* Busby, "Arizona Increasing Limits on Attorney Fee Awards in Tax Cases," *State Tax Notes*, June 22, 2015, p. 929.

[7] *See* Busby, "More Taxpayers May Soon Appeal Directly to the Arizona Tax Court," *State Tax Notes*, May 28, 2018, p. 903.

subject to tax, may want to clarify whether the tax is lawfully due by filing protective refund claims, although they may choose to hedge their bets by continuing to collect tax from their customers while their claims are pending.

Some of us feel so strongly that digital goods and services are not subject to Arizona's taxes on proceeds from selling or renting tangible personal property that we are willing to pursue many of those cases on a contingent fee basis. If someone is going to get sued because Arizona's Legislature failed to specify what is taxable, it should be the DOR and not taxpayers who have more important things to do than grapple with the DOR's fanciful interpretations of Arizona's outdated tax code! ■