

Will Arizona's Legislature Specify Which Digital Goods Are Taxable?

by James G. Busby Jr.

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In this installment of SALT From My Saddle, Busby discusses an issue taxpayers hope to see addressed in 2019: Will Arizona lawmakers finally specify which digital goods are taxable and clarify that digital services are not?

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Unlawfully Taxing Digital Goods and Services

For years, taxpayers have been blindsided by sales tax assessments alleging that proceeds from various digital goods and services are subject to tax in Arizona. Although Arizona lawmakers have not addressed the issue, state and local taxing authorities argue in confidential audit assessments and obscure private taxpayer rulings that proceeds from digital goods and services are subject to tax as rentals of tangible personal property under the state's antiquated tax code.¹

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

The 2017 Legislative Study Committee

In 2017 a Joint Legislative Ad Hoc Study Committee explored the issue and released a report. At the time, legislative leaders stressed the need for clarity, acknowledged that the state's tax statutes have not kept pace with the digital economy, and emphasized that the Arizona tax code must be "predictable, transparent and fair for all taxpayers."²

Legislative Failure and Voters' Mandate

H.B. 2479, which the Arizona House of Representatives passed by a comfortable margin early in the 2018 session, would have clarified that prewritten computer software and a specified list of digital goods are taxable but prohibited the Department of Revenue and municipalities from taxing some digital services. However, Senate leaders opted not to call for a vote on the bill after opponents questioned how it might affect the state's budget and 50,000 Arizona teachers marched throughout the state demanding a 20 percent pay raise.³

In November an overwhelming majority (nearly two-thirds) of Arizona voters passed Proposition 126, which amended the Arizona Constitution to prohibit the state and its political subdivisions from increasing or imposing new taxes on services not in effect December 31, 2017.⁴

² See Busby, "Arizona Intends to Clarify Taxation of Digital Goods and Services," *State Tax Notes*, Feb. 19, 2018, p. 711.

³ See Busby, "Arizona Left Providers of Digital Goods and Services in a Pickle," *State Tax Notes*, June 4, 2018, p. 1003.

⁴ See Busby, "Arizona Constitutional Amendment Prohibits New Taxes on Services," *State Tax Notes*, Nov. 26, 2018, p. 781.

What to Expect in 2019

The November election also resulted in a smaller Republican House majority. Given this dynamic, insiders believe that the business community will back a bill this year that will allow Arizona taxing authorities to collect tax on most digital goods in the future but, given the passage of Proposition 126, insist that lawmakers clarify digital services are not taxable.

With Proposition 126 in place, how will lawmakers and Gov. Doug Ducey (R) respond? Will they act in 2019 to specify which digital goods are taxable and, now that they are constrained by Proposition 126, that digital services are not? Or will they continue to allow Arizona tax authorities to run wild, forcing providers of digital goods and services into the untenable position of choosing to collect taxes from their customers that may not be lawfully due, thereby exposing themselves to potential class action lawsuits — or not collect taxes from their customers, thereby exposing themselves to potential audit assessments and legal fees to challenge the same? Stay tuned. ■

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