IN THE
Supreme Court of Arizona

NO. CV-23-0036-PR

Ct. App. No. 1 CA-TX-21-0009

Arizona Tax Court Nos. TX2018-000246,
TX2019-000066, TX2019-000067
(Consolidated)

ADP, LLC,

Plaintiff/Appellant

v.

ARIZONA DEPARTMENT OF REVENUE

Defendants/Appellees.

BRIEF OF *AMICUS CURIAE* COUNCIL ON STATE TAXATION IN SUPPORT OF PLAINTIFF/APPELLANT (FILED WITH WRITTEN CONSENT)

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INTERESTS OF *AMICUS CURIAE*

The Council On State Taxation ("COST") is a nonprofit trade association based in Washington, D.C. COST was organized in 1969 as an advisory committee to the Council of State Chambers of Commerce. Today, COST has an independent membership of over 500 of the largest multistate corporations engaged in interstate and international business. COST represents companies doing business in every state across the United States and the world. COST members employ a substantial number of Arizonans, own extensive property in Arizona, and conduct substantial business in Arizona.

COST's objective is to preserve and promote equitable and non-discriminatory state and local taxation of multijurisdictional business entities. In furtherance of this objective, COST has participated as *amicus curiae* in many significant federal and state tax cases since its formation, including cases in which Arizona courts have considered important state and local tax issues. COST filed *amicus* briefs over the last decade in *First Data Corp. v. Arizona Department of Revenue*, 233 Ariz. 405, 313 P.3d 548 (Ct. App. 2013), *Harris Corp. v. Arizona Department of Revenue*, 233 Ariz. 377, 312 P.3d 1143 (Ct. App. 2013), *pet. denied*, No. CV-13-0375-PR, 2014 Ariz. LEXIS

145 (Ariz. 2014), and *Home Depot U.S.A., Inc. v. Arizona Department of Revenue*, 233 Ariz. 449 (Ct. App. 2013), *pet. denied*, No. CV-13-0377-PR, 2014 Ariz. LEXIS 111 (Ariz. 2014).

This case involves an issue of great importance to COST members: whether an administrative agency can alter the interpretation of a state law intended to apply exclusively to tangible personal property and extend its reach to digital services. The answer should be "no." Arizona cannot impose its transaction privilege tax ("TPT") on digital products, specifically on a Software as a Service ("SaaS"), under an unrevised, pre-digital economy statute grounded on the inclusion of rentals or leases of tangible personal property in the tax base.[1]

COST provides the unique perspective of a trade association with members who are engaged in business in all 50 states and are required to comply with differing sales and use tax rules in those jurisdictions. Increasingly, sales tax compliance activities include addressing the taxation of digital products, particularly determining whether these

[1] *See* Senate Bill 1460 (Ariz. 2019); House Bill 2585 (Ariz. 2023) (the Arizona Legislature considered providing specific tax treatment of prewritten computer software, digital goods, and digital services for TPT purposes).

products constitute taxable tangible personal property or services under a state's statutes.[2] COST is vested in this case because fair tax administration depends upon equitable administration of state tax laws. The Court of Appeals' opinion in this case puts that principle at risk in Arizona.

No person or entity other than the *amicus curiae* identified herein provided financial resources for the preparation of this brief.

INTRODUCTION

The modern digital economy is often not addressed within the states' traditional sales tax statutes. New digital business models allow sellers to provide services over the Internet without utilizing more traditional labor or tangible property-intensive processes in the state where a purchaser uses those services. The taxability of these new digital services depends on whether the transactions fit within traditional statutory definitions of tangible personal property or enumerated taxable services, or whether state legislatures have changed tax laws to address the new business models.

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[2] Although not required to do so, sellers are expressly permitted to pass the TPT on to their customers, Ariz. Admin. Code R15-5-2210, so generally the TPT is viewed as a type of sales tax.

In this case, neither the existing statutes in Arizona apply to ADP, LLC's ("ADP") digital services, nor has the Arizona Legislature acted to provide new statutory authority to impose the TPT on these services.[3] Instead, the Department of Revenue (the "Department"), in an administrative action erroneously affirmed by the Court of Appeals, has extended existing rules for imposing a TPT on tangible personal property far beyond their intended reach so as to apply to digital services. This Court should grant ADP's Petition for Review to vacate the Court of Appeals' decision and preserve the Arizona Legislature's sovereignty over TPT taxability decisions.

ADP's payroll processing service, accessed remotely through digital software (called "eTime"), is not a rental of tangible personal property. The eTime service is SaaS. The National Institute of Standards and Technology ("NIST") describes the SaaS model as follows:

> A cloud service [that] can provide access to software applications, such as email or office productivity tools (i.e., the Software as a Service, or SaaS, service model) . . . A cloud system that deploys the SaaS model can be accessible over a network by an end user utilizing various client devices (e.g., a thin client interface, such as a web browser, for accessing a web-

[3] *See supra* note 1.

> based email application) or via a program with the correct set of interfaces whose execution would enable communication with a cloud application.

NIST, U.S. Dep't of Commerce, *General Access Control Guidance for Cloud Systems, Special Publication 800-210* (July 2020), https://csrc.nist.gov/publications/detail/sp/800-210/final.

eTime, utilizing the SaaS model, is not a rental or lease of tangible personal property as defined by A.R.S. § 42-5001(21) and A.R.S. § 42-5071(A). Moreover, the Court of Appeals' decision makes Arizona an extreme outlier among states, authorizing improper administrative action to tax certain digital products without statutory authority. Taxing eTime also violates the federal Internet Tax Freedom Act ("ITFA"), 47 U.S.C. § 151 note at ITFA § 1101, because it is a discriminatory tax on electronic commerce.

ARGUMENT

Since its inception, ADP has been a provider of human resource management and payroll processing services that are not included in the TPT tax base. The change of ADP's business model to provide human resource management and payroll processing services using a digital

format and not in-person services does not transform the underlying transaction into a taxable service or into tangible personal property.

ADP's underlying services have not changed, and Arizona's tax laws have not changed either. Accordingly, Arizona should not inappropriately try to shoehorn ADP's payroll processing services accessed remotely through digital software (SaaS) into a TPT tax base category that applies to the lease or rental of tangible personal property.

I. There is no statutory authority to include eTime in the TPT tax base as the lease or rental of tangible personal property.

The Court of Appeals relied on a 1943 case on the taxability of using jukeboxes, *State v. Jones*, 60 Ariz. 412, 137 P.2d 970 (Ariz. 1943), and a 1970 case on the taxability of using washers and dryers, *State Tax Commission v. Peck*, 106 Ariz. 394, 476 P.2d 849 (Ariz. 1970), to support its holding that the eTime digital service (SaaS) is taxable as the lease or rental of tangible personal property. These cases, however, involve completely different fact patterns, and do not justify a finding that digital payroll processing services, are subject to TPT as the lease or rental of tangible personal property.

A. *Jones* cannot be stretched to apply to digital services.

The Court of Appeals found that *Jones* is "not factually distinguishable from this case in any material way" and as a result, the *Jones'* holding applies to the facts in this case. *ADP, LLC v. Ariz. Dep't of Revenue*, 524 P.3d 278, 283, 2023 Ariz. App. LEXIS 45 (Ct. App. 2023). In *Jones*, a 1943 decision, this Court found that placing a coin into a jukebox to play a song from a record was a sale of tangible personal property under the excise revenue act. *Jones*, 60 Ariz. at 415. "The playing of the record is perceptible to the sense of hearing, and hence, constitutes what the statute terms tangible personal property." *Id.*

The Court of Appeals acknowledged that computer software did not exist at the time that *Jones* was decided, but that is where the Court of Appeals ended the distinctions between jukeboxes and eTime. Instead, the Court of Appeals found jukeboxes and eTime were comparable because "just as jukeboxes play songs from records for patrons to hear, modern computers run programs viewable to users that enable them to utilize the software to accomplish specific tasks." *ADP*, 524 P.3d at 283. The Court of Appeals broadly concludes that "[b]oth jukeboxes and computers produce perceptible effects, for which their users are willing to pay." *Id.* This generalization characterizes eTime (and invariably anything that can be

viewed on a computer) as tangible personal property. This holding obliterates the distinction between a digital service and tangible personal property by utilizing an oversimplified and perfunctory analysis.

Jones correctly notes that hearing music is the intended outcome of putting money into a jukebox, and the sale of that auditory experience is the purpose of the jukebox transaction. But that is not the case with eTime. ADP is not selling what Maricopa County (the "County") employees see on their computer screens when they look at eTime's graphical user interface. The County uses eTime for ADP's nontaxable administrative human resource and payroll services. *See Qwest Dex, Inc. v. Ariz. Dep't of Revenue*, 210 Ariz. 223, 109 P.3d 118 (Ct. App. 2005) (printing a telephone directory is a nontaxable service under the objective, dominant-purpose test and the common-understanding test.). eTime collects the necessary data from the County, *e.g.*, County employees' time and leave information, to provide the County with payroll processing services.

The Court of Appeals holds that "*Jones*' analysis did not turn on the particular mechanism involved but rather on the perceptibility of what was being purchased." *ADP*, 524 P.3d at 283. The Court of Appeals focuses on the perceptibility of a computer running viewable programs, *i.e.*, the

perception of eTime on an employee's computer. But the Court of Appeals provided no analysis on what was purchased, which in this case was human resource and payroll services. These services are not perceptible (regardless of whether provided in digital or non-digital form). The County and its employees are also not able to control these services, unlike a jukebox, where the purchaser controls the music being played by the jukebox. Lastly, unlike the jukebox that was physically present in Arizona, the software was not physically located in the State. Petition at 3. In sum, *Jones* cannot be stretched to include digital services.

B. *Peck*'s rental analysis does not apply to digital services.

The Court of Appeals' misapplication of *Peck* equally warrants review. In *Peck*, this Court found that coin-operated laundry machines and car-washing machines, operated by customers, were subject to TPT as renting tangible personal property. The customers rented the machines because they gained "exclusive use and control" of "all manual operations necessary to run the machines." *Peck*, 106 Ariz. at 396.

Applying *Peck* to the facts in this case, the Court of Appeals found that the County's use of eTime is akin to the customers' use of laundry machines and car-washing machines. "Much like laundromat customers

pay for use of laundry machines, the County pays ADP fees in exchange for using its configured version of eTime." *ADP*, 524 P.3d at 284. Thus, the Court of Appeals concluded that ADP rented eTime services to the County.[4]

This analysis, however, is a strained application of *Peck*. As ADP aptly explained, "it is obvious that [County] Employees do very little of the [payroll] activities necessary to obtain their paychecks; Employees only enter hours worked and pay type." Petition at 8-9. This is vastly different than going to a laundromat, where the customer must perform all the activities to get clean clothes. *See* Petition at 9 (detailing activities a

[4] When evaluating the taxability of eTime under the City of Phoenix's (the "City") version of the Model City Tax Code, P.C.C. § 14-450, however, the Court of Appeals found that ADP is subject to TPT as a "licensing for use" of tangible personal property. *ADP*, 524 P.3d at 287. The Court of Appeals could have simply re-iterated its earlier rental analysis and found that eTime is subject to the City's TPT under P.C.C. § 14-450, but instead chose an incongruent and inconsistent "licensing for use" analysis. And importantly, while P.C.C. § 14-450 (and all corresponding Model City Tax Code sections in all cities) applies to "leasing, *licensing for use*, or renting tangible personal property" (emphasis added), the state personal property rental classification applies only to the "leasing or renting tangible personal property" and **not** to the "licensing for use" of tangible personal property. A.R.S. § 42-5071(A). Thus, under the Court of Appeals' characterization of eTime as a license for use for City TPT purposes, it would not be taxable under the State personal property rental classification.

laundromat customer performs to get clean clothes).

To stay within a clean clothes analogy, eTime is more comparable to going to a dry cleaner. Dry cleaner customers go to the store to obtain clean clothes that they do not have the capability to clean themselves. The customers drop off their dirty clothes at the dry cleaners (a necessary requirement), but the dry cleaners clean the customers' clothes. The dry cleaners do not rent any tangible personal property to their customers. The customers are paying the dry cleaners for their services and providing the clothes for the dry cleaners to perform their services on.

Similarly, County employees "drop off" their data—their hours and pay type information— through eTime. This must be done for ADP to provide its human resources and payroll services, *e.g.*, paystubs. Without this, ADP cannot complete its transaction with the County. Unlike *Peck*, where laundromat customers were washing their own clothes as facilitated by rented equipment, the County and its employees are not doing anything once the data is entered into eTime. "Exclusive use and control" is necessary for a rental, and ADP's customers simply are not controlling

eTime.[5] And again, the laundromat equipment was also located in Arizona, which is not the case with eTime's software. Petition at 3.

County employees only interact with eTime's graphical user interface, which is not equivalent to exercising exclusive use and control over eTime. According to the NIST, in a SaaS model, "a cloud service provider delivers an application as a service to end users through a network such as the internet." NIST, U.S. Dep't of Commerce, *General Access Control Guidance for Cloud Systems, Special Publication 800-210* (July 2020), https://csrc.nist.gov/publications/detail/sp/800-210/final. A "consumer is to use the provider's applications running on a cloud

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[5] The Court of Appeals was overhasty in dismissing ADP's comparison of eTime to cases where a service was provided with tangible personal property that was not possessed or controlled by the service provider's customer as "untenable" because these cases were for service transactions. *ADP,* 524 P.3d at 285 (referencing *Phoenix v. Bentley-Dille Gradall Rentals*, 136 Ariz. 289, 665 P.2d 1011 (Ct. App. 1983) (construction equipment provided with an operator was not a taxable rental because the customer did not have possession and control of the equipment), *Jones Outdoor Advert., Inc. v. Ariz. Dep't of Revenue*, 238 Ariz. 1, 355 P.3d 603 (Ct. App. 2015) (billboard company was not renting its billboards because its customers only had the right to have messages displayed on the billboards, not possession or control of the billboards), and *Energy Squared, Inc. v. Ariz. Dep't of Revenue*, 203 Ariz. 507, 56 P.3d 686 (Ct. App. 2002) (tanning salon was not renting tanning beds because the beds were controlled by tanning technician service providers)). But that is the point—eTime is a service.

infrastructure. The applications are accessible from various client devices through either a thin client interface, such as a web browser (e.g., web-based email), or a program interface." NIST, U.S. Dep't of Commerce, *The NIST Definition of Cloud Computing, Special Publication 800-145* (Sept. 2011), http://csrc.nist.gov/publications/nistpubs/800-145/SP800-145.pdf. Importantly, the NIST details that "[t]he consumer *does not manage or control the underlying cloud infrastructure* including network, servers, operating systems, storage, or even individual application capabilities, with the possible exception of limited user specific application configuration settings." *Id.* (emphasis added). Similarly, the United States Department of Interior explains that in a SaaS model, the customer is responsible for "people" (*e.g.*, the customer's users who interact with the interface) and "data" (*e.g.*, the information inputted by the customer's users). U.S. Dep't of Interior, *Foundation Cloud Hosting Services: Cloud Service Models*, https://www.doi.gov/cloud/service (last visited May 15, 2023). The cloud service provider (also known as a "CSP"), however, is exclusively responsible for "Applications, Runtime, Middleware, Operating System, Virtual Network, Hypervisor, Servers, Storage, Physical Network." *Id.*

eTime operates through an underlying SaaS infrastructure that goes far beyond the County employees' interaction with and access to its graphic user interface. The County and its employees do not have control of the SaaS infrastructure. Access does not equate to control. Without that distinction, there is no prerequisite exclusive control of eTime (or any other SaaS) for the transaction to be deemed a rental of tangible personal property.

II. Arizona's treatment of digital products as taxable without statutory authority makes the State an outlier.

The Court of Appeals' decision, sanctioning the Department's inclusion of eTime in the TPT tax base without clear statutory authority, makes Arizona an outlier among states that impose a sales tax on SaaS. No other state definitively asserts that SaaS transactions are taxable as tangible personal property without a statutory grant of authority specifying the taxability of digital products through an expansion of the definition of tangible personal property or as an enumerated taxable service.

In 2018, COST issued its first scorecard ("Scorecard") reviewing the states' overall sales tax administration. The Scorecard was updated in 2022. COST, *Best and Worst of State Sales Tax System* (December 2022),

www.cost.org/globalassets/cost/state-tax-resources-pdf-pages/cost-studies-articles-reports/cost-2022-sales-tax-systems-scorecard.pdf.

The Scorecard "objectively evaluates state statutes and rules that govern state and local tax departments' administration of their sales taxes." *Id*. at 1. The Scorecard includes an analysis of how states tax sales of software and digital products and illustrates how the Court of Appeals' decision is completely out of step with all other states in the nation.

As part of the Scorecard's review of state sales taxes on digital products, it evaluated "whether a state's sales tax on digital products is based on clear statutory authority." *Id*. at 14. It found that "[a]bout one-half of the states imposed a sales tax on digital software accessed remotely (SaaS)." *Id*. The following chart (entitled "States-Level Sales Tax on SaaS") details those states that impose a state-level sales tax on SaaS transactions.

States-Level Sales Tax on SaaS	
State	**Authority**
Alabama	No clear state SaaS guidance.
Arizona	State tax agency has interpreted "tangible personal property" to include SaaS. *ADP*, 524 P.3d at 281.
Connecticut	Taxed by statute as "electronically accessed" "prewritten computer software." C.G.S. § 12-407(a)(13).
District of Columbia	Taxed by statute as "data processing and information services." D.C. Code Ann. § 47-2001(n)(1)(N).

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States-Level Sales Tax on SaaS	
State	**Authority**
Hawaii	Taxed by statute as "tax on other business." Haw. Rev. Stat. § 237-13(9).
Iowa	Taxed by statute as "software as a service." Iowa Code § 423.2(6)(bu).
Kentucky	Taxed by statute as "prewritten computer software access service." Ky. Rev. Stat. Ann. § 139.200(2)(ay).
Louisiana	No clear state SaaS guidance.
Maryland	Taxed by statute as "digital product." Md. Code Ann. Tax-Gen. § 11-102(a).
Massachusetts	Taxed by statute as "standardized computer software." Mass. Gen. L. ch. 64H, §§ 1, 2.
Mississippi	Taxed by statute as "computer software sales and services." Miss. Code Ann. § 27-65-23.
New Mexico	Taxed by statute as "digital good" or "service." N.M. Stat. Ann. §§ 7-9-3(C), 7-9-3.5.
New York	Taxed by statute as "pre-written computer software." N.Y. Tax Law § 1101(b)(6).
Ohio	Taxed by statute as "computer services." Ohio Rev. Code Ann. §§ 5739.01(B)(3)(e), 5739.01(Y)(1)(b).
Pennsylvania	Taxed by statute as "canned computer software" "whether electronically or digitally delivered, streamed or accessed." 72 PS § 7201(m)(2).
Rhode Island	Taxed by statute as "vendor-hosted prewritten computer software." R.I. Gen. Laws §§ 44-18-7(15), 44-18-7.1(g)(vii).
South Carolina	Taxed by statute as "communications" service. S.C. Code Ann. §§ 12-36-60, 12-36-910(B)(3), 12-36-1310(B)(3).
South Dakota	Taxed by statute as "any product transferred electronically." S.D. Codified Laws Ann. §§ 10-45-4, 10-45-4.1, 10-45-5.
Tennessee	Taxed by statute as "computer software" "delivered electronically." Tenn. Code Ann. § 67- 6-231.
Texas	Taxed by statute as "data processing services." Tex. Tax Code §§ 151.0035, 151.0101(a)(12), 151.351.
Utah	Taxed by statute as "prewritten computer software,

States-Level Sales Tax on SaaS	
State	**Authority**
	regardless of the manner in which...transferred." Utah Code § 59-12-102(130).
Washington	Taxed by statute as "right to access and use prewritten computer software." R.C.W. § 82.04.050(6)(c).
West Virginia	Taxed by statute as "all services." W. Va. Code §§ 11-15-8, 11-15A-2.

All but three[6] of the above-listed states tax SaaS through a statutory provision that encompasses:

(1) a broad application to almost all business activities (such as Hawaii's general excise tax);

(2) an application to services broadly or to specifically enumerated services (such as the District of Columbia's enumeration of "data processing and information services" as taxable); or

(3) enumerated digitally transmitted software (such as Iowa specifying "software as a service" as taxable).[7]

[6] "Of these [states that impose a state sales tax on SaaS transactions], three (Alabama, Arizona, and Louisiana) do so without clear statutory authority." *Best and Worst of State Sales Tax System* at 14. The state tax agencies in Alabama and Louisiana have not adopted a formal position on the taxability of SaaS transactions. *See Best and Worst of State Sales Tax System* at 41, 58.

[7] *Amicus* do not address the applicability of exemptions, *e.g.,* business-to-business exemptions, different applicable rates, or whether SaaS is appropriately taxable under these state statutory provisions.

Arizona, however, is an outlier that imposes a state-level sales tax on SaaS transactions as "tangible personal property" without clear statutory authority.[8] If this Court does not review this case and reverse, Arizona will remain an outlier.[9] And more importantly, the question of whether and how digital services are to be taxed is one for the Arizona Legislature and not the Department.

III. Applying TPT to eTime violates the Internet Tax Freedom Act.

The Internet Tax Freedom Act (ITFA), initially enacted by the U.S. Congress in 1998, prohibits imposing "discriminatory taxes on electronic

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[8] Moreover, Arizona canons of statutory construction prohibit the Department from re-interpreting a statute simply to expand the tax base without any change to the statute or the activity now being taxed. *See Dennis Dev. Co. v. Dep't of Revenue*, 122 Ariz. 465, 467–68 (Ct. App. 1979) (holding that the Department could not, decades after a statute was enacted, adopt a new regulation expanding the tax base to include previously nontaxable receipts); *see also City of Peoria v. Brink's Home Sec., Inc*, 247 P.3d 1002, 226 Ariz. 332, *on remand*, 261 P.3d 473, 227 Ariz. 589 (Ariz. 2011) (the court reads tax provisions to gain their fair meaning, but not to gather new objects of taxation by strained construction or implication).

[9] The Arizona Legislature has also expressed similar concern: the final report from the Arizona Legislature's 2017 Joint Ad Hoc Committee on the Taxation of Digital Goods and Services found that "taxing authorities need statutory direction regarding what constitutes a taxable event for digital goods," which warranted consideration of "legislation to provide such clarity." IR 64, n. 13; *see also* Petition at 6.

commerce." ITFA § 1101(a)(2).[10] The term "electronic commerce" means "any transaction conducted over the Internet . . . comprising the sale, lease, license, offer, or delivery of property, goods, services, or information." ITFA § 1105(3). ITFA defines a "discriminatory tax" as one that "is not generally imposed and legally collectible by such State or such political subdivision on transactions involving similar property, goods, services, or information accomplished through other means." ITFA § 1105(2)(A)(i). This anti-discrimination provision is intended to "capture instances where State or local tax policies seek to place electronic commerce at a disadvantage compared to similar commerce conducted through more traditional means." H.R. Rep. No. 105-570, pt. 1, at 33.

In the instant case, the inclusion of eTime in the TPT tax base constitutes a "discriminatory tax" in violation of the ITFA. ADP has been in the same business for over 80 years. Petition at 16. ADP's human resource management and payroll processing services were not previously subject to the TPT when provided as non-digital services. The change to a

[10] Congress initially enacted ITFA on a "temporary" basis, and subsequently extended its application three times before making it permanent in 2015. *See* Pub. L. 114-125, § 922 (2015).

digital format for providing the exact same services cannot be included in the TPT tax base unless similar non-digital services are also included in the TPT tax base, which they are not. ADP has simply taken advantage of technology to be more efficient and cost-effective. The ITFA "discriminatory tax" provision clearly protects taxpayers where a state is seeking to disadvantage a business model, such as eTime, which is entirely accessed through digital technology and not more traditional non-computer-based services.

CONCLUSION

For the foregoing reasons, this Court should grant ADP's Petition for Review and vacate the Court of Appeals' decision.

DATED this 19th day of May, 2023.

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