THE SUPERIOR COURT OF THE STATE OF ARIZONA
IN THE ARIZONA TAX COURT

[redacted] [redacted]

HONORABLE ERIK THORSON

CLERK OF THE COURT
M. R. Diaz
Deputy

[redacted] JAMES G BUSBY JR.

v.

ARIZONA DEPARTMENT OF REVENUE BENJAMIN H UPDIKE

MINUTE ENTRY

The Court has received and reviewed the following, as well as all subsequent filings related thereto, and considered the arguments of the Parties made on [redacted].

1. Defendant Arizona Department of Revenue's Motion for Summary Judgment, filed [redacted];
2. Plaintiff [redacted] Motion for Summary Judgment, filed [redacted]; and
3. Plaintiff's *Daubert* Motion to Exclude Testimony of Tamal Bose and Limit Testimony of Kevin O'Bryan and Lavelle Bland, filed [redacted].

Plaintiff [redacted] ("[redacted]") describes itself as an Internet Service Provider that provides internet access services out of a data center. (Plaintiff's Statement of Facts, filed [redacted] ("PSOF"), at ¶1.) Defendant, the Arizona Department of Revenue (the "Department"), does not dispute that [redacted] provides internet connections to some of its customers and that some of what [redacted] does is act as an Internet Service Provider, but Defendant does dispute [redacted] characterization of its business as internet access services. (Defendant's Controverting Statement of Facts, filed [redacted] ("DCSOF"), at ¶1.)

[redacted] provides services to its customers that include: (1) providing high-speed internet connections; (2) providing uninterrupted power; (3) providing generator back-up services; (4)

[redacted] [redacted]

controlling temperature, humidity, and particulate matter in the data center; (5) securing the data in the data center with electronic doors and gates, alarms, video monitoring, and security personnel; (6) providing fire suppression services; and (7) retaining onsite technicians 24/7/365. (PSOF ¶4, *undisputed that these are provided at* [redacted]

[redacted] customers pay for: (1) colocation services (utilization by customers of small spaces within data center to set up servers); (2) infrastructure as a service ("IaaS") services (utilization by customers of [redacted] owned servers); (3) ancillary services (including additional bandwidth, domain name use, managed services, non-recurring charges, other recurring charges, and security services); and (4) office space and software. (PSOF ¶10, *disputed as to characterization as a service*.)

The City of Phoenix under authorization from the Department audited [redacted] for state, county, and city transaction privilege tax ("TPT") for the period of [redacted] through [redacted]. (Defendant's Statement of Facts, filed [redacted] ("DSOF"), at ¶1, *undisputed*.) ADOR issued a Notice of Proposed Assessment (the "Assessment") and initially assessed a total tax of $[redacted]. (DSOF ¶1, *undisputed*; PSOF ¶48, *undisputed*.)[1]

The Assessment included the following: (1) $[redacted] for TPT under the state's commercial lease classification; (2) $[redacted] for TPT under the state's personal property rental classification; (3) [redacted] for TPT under the City of Phoenix's commercial lease classification; (4) $[redacted] for TPT under the City of Phoenix's personal property rental classification; (5) $[redacted] for penalties; and (6) $[redacted] for interest calculated from [redacted], which continues to accrue at a rate of over $[redacted] per day. (PSOF ¶49, *undisputed*.) On [redacted], [redacted] filed its Complaint appealing the Assessment. (Compl., filed [redacted].)

The Department[2] seeks summary judgment finding that renting space in a data center is taxable rental of commercial real property and renting servers is a rental of tangible personal property. (Def.'s Mot., at 17.) On the other hand, [redacted] seeks summary judgment on all issues raised in its Complaint. (*See generally* Pl.'s Mot.)

Summary judgment is appropriate if "there is no genuine dispute as to any material fact and the moving party is entitled to judgment as a matter of law." Ariz. R. Civ. P. 56(a); *General*

[1] The tax was subsequently reduced by $[redacted] due to a change during this case that treated "bandwidth" charges as exempt interstate telecommunication. (DSOF ¶1, *undisputed*; *see also* DSOF ¶10, *undisputed*.)

[2] Although this case involves tax under the Phoenix City Code, the Department is tasked with collecting and administering the tax pursuant to A.R.S. § 42-6001(A).

[redacted] [redacted]

Motors Corp. v. Maricopa Cty., 237 Ariz. 337, 339 ¶7 (App. 2015). "In the tax field, we liberally construe statutes imposing taxes in favor of taxpayers and against the government, . . . but strictly construe tax exemptions because they violate the policy that all taxpayers should share the common burden of taxation." *State ex rel. Ariz. Dep't of Revenue v. Capitol Castings, Inc.*, 207 Ariz. 445, 447 ¶10 (2004) (internal citations omitted).

The City of Phoenix imposes a privilege tax "equal to two and eight-tenths percent of the gross income from the business activity upon every person engaging or continuing in the business of leasing or renting real property located within the City for a consideration[.]" City Code § 14-445(a). The City of Phoenix imposes "an additional tax in an amount equal to one-tenth of one percent of the gross income from the business activity of any person engaged in rental, leasing or licensing of nonresidential property or property units." City Code § 14-446. Maricopa County also imposes a tax under A.R.S. § 42-5069(A) on "the business of leasing for a consideration the use or occupancy of real property."

The City of Phoenix imposes a privilege tax "equal to two and eight-tenths percent of the gross income from the business activity upon every person engaging or continuing in the business of leasing, licensing for use, or renting tangible personal property for a consideration[.]" Phoenix City Code ("City Code") § 14-450(a). The state and county also impose taxes under A.R.S. § 42-5071 on "the business of leasing or renting tangible personal property for a consideration."

At issue is whether [redacted] provided nontaxable services or is subject to the TPT applicable to the rental of real property and tangible personal property for colocation and server rentals. (Pl.'s Mot., at 1; Def.'s Mot., at 2.)

"In construing a statute, [the Court] look[s] to the plain language of the statute, giving effect to every word and phrase, and assigning to each word its plain and common meaning." *Ponderosa Fire Dist. v. Coconino Cty.*, 235 Ariz. 597, 602 (App. 2014) (citations omitted).

As to colocation, the Department contends that [redacted] customers obtain space in cages and racks. (Def.'s Mot., at 11.) [redacted] contends that it does not charge for colocation services on a per-square-foot basis but instead on the amount of data center services it provides the customer each month. (Pl.'s Mot., at 12.) However, nothing in City Code §§ 445 and 446 and A.R.S. § 42-5069 requires that rental of real property be billed on a per-square-foot basis.

[redacted] further contends that what it charges colocation customers is significantly more than the rental rate for warehouse space or fully equipped data centers. (Pl.'s Mot., at 2.) The Department contends that the nature of the transaction determines the tax classification—not the price paid. (Def.'s Resp. to Pl.'s Mot., filed [redacted], at 12.) The Court agrees. Here, [redacted] is renting out space in its data centers for customers to set up their servers.

[redacted] [redacted]

As to the server rentals, the Department asserts that there is no dispute that the computer hardware (i.e., servers) and software are tangible personal property under A.R.S. § 42-5001(21). (Def.'s Mot., at 12.) The Department contends that a customer paying to use [redacted] servers is a rental under *State Tax Commission v. Peck*, 106 Ariz. 394 (1970). (Def.'s Mot., at 12.)

In *Peck*, the Court found that taxpayers owning a laundromat and automatic carwash were subject to TPT as businesses leasing or renting tangible personal property. 106 Ariz. at 395–96. The Court found:

> There is no question that when customers use the equipment on the premises of the plaintiffs herein, such customers have an exclusive use of the equipment for a fixed period of time and for payment of a fixed amount of money. It is also true that the customers themselves exclusively control all manual operations necessary to run the machines. In our view such exclusive use and control comes within the meaning of the term 'renting' as used in the statute.

Id. at 396. In *Energy Squared, Inc. v. Ariz. Dep't of Revenue*, the Court of Appeals distinguished *Peck* when evaluating a tanning salon business. 203 Ariz. 507, 511 ¶25 (App. 2002). The Court found:

> Unlike the owners of coin-operated, self-service laundries and car washes, the taxpayer customizes each of its patrons' use of UV-radiation-generating devices to maximize customer safety and optimize tanning results according to the customer's wishes. It is true that the owner of a coin-operated, self-service laundry or car wash may have the raw power to interrupt its customer's use of its equipment. In the instant case, however, the taxpayer reserves overall control over its customers' use of tanning devices not merely by virtue of its control over its premises, but rather as a part of the business design by which it provides artificial tanning.

Id. The Court of Appeals found that the operating of tanning salons did not constitute the renting of tangible personal property. *Id*. at 511 ¶27.

In *Energy Squared*, the tanning technicians exclusively controlled whether a tanning session could commence, how long the session could last, and which tanning device was appropriate. *Id*. at 510 ¶22. Additionally, the taxpayer had to obtain information from the customer, assess the information, provide advice to the customer, determine the maximum exposure the

[redacted] [redacted]

customer could be allowed to undergo, and enforce its determination through the central control of the tanning equipment. *Id*. at 511 ¶23.

As the Department contends, *Energy Squared* is distinguishable because [redacted] does not operate the servers or data center space—[redacted] customers operate the servers they rent. (*See* Def.'s Resp., at 18.)

More recently, in *ADP, LLC v. Arizona Dep't of Revenue*, the Court of Appeals found that use of remotely hosted software was a taxable rental. 254 Ariz. 417, 423 ¶15 (App. 2023). Addressing the distinction between services and property, the Court found:

> To the extent ADP argues there are services included within the eTime charges, those services are secondary and necessary components of its software rental. We agree with ADOR that the services ADP provides (such as maintenance, troubleshooting, customer service, software configuration and updates, and technical fixes) are normal components of ADP's software rental business. Any "services" purportedly bundled are secondary to the taxable component of the transaction, the fees charged for the County's use of eTime, and therefore taxable.

Id. at 425 ¶24. **THE COURT FINDS that** the services [redacted] provides are akin to the services ADP provided that the Court of Appeals found were secondary and necessary components of software rental. Here, the services [redacted] provides are also necessary components of colocation and server rentals. (*See* PSOF ¶4.)

[redacted] contends that it provided hundreds of employees and independent contractors to operate its data center like in *City of Phoenix v. Bentley-Dille Gradall Rentals, Inc.*, 136 Ariz. 289 (App. 1983). (Pl.'s Resp. to Def.'s Mot., filed [redacted], at 2, 8.) The Department contends that [redacted] does not operate the rented servers nor is the data center space operated, but rather [redacted] houses customers' servers and the customers operate the servers they rent. (Def.'s Resp., at 18.)

In *Bentley-Dille*, the Court of Appeals held "as a matter of law that appellant did not give up possession and control of the Gradalls when it provided them to various construction projects with operators and thus, such activity was not 'renting' within the meaning of the transaction privilege tax." 136 Ariz. at 292. Here, [redacted] does not exercise the same control over the rented space or servers as that exercised over the machinery provided along with trained operators in *Bentley-Dille*.

[redacted] relies on *Val-Pak East Valley, Inc. v. Ariz. Dep't of Revenue*, 229 Ariz. 164 (App. 2012) and *Qwest Dex, Inc. v. Ariz. Dep't of Revenue*, 210 Ariz. 223 (App. 2005) which address the "dominant purpose" and "common understanding" tests. (Pl.'s Mot., at 13–15.) The Department contends that *Val-Pak* and *Qwest Dex* are irrelevant to taxable rentals of personal property. (Def.'s Resp., at 14–17.) *Val-Pak* and *Qwest Dex* both involved printing services and use tax rather than TPT.

The Department contends that the "dominant purpose" test analyzed in *Val-Pak* and *Qwest Dex* has an inherent defect when applied to rental property because the customer's needs often cannot be satisfied without both the services and the tangible property. (Def.'s Resp., at 16–17.) The Department also notes that the supplying of utilities to make the laundry machines functional in *Peck* did not prevent a finding that the laundry machines were rented for purposes of TPT. (Def.'s Resp., at 17.)

In *Val-Pak*, the Court of Appeals explained that there are three scenarios common in the treatment of transactions involving both tangible personal property and services:

> [F]irst, the service is the primary object of the transaction and the property is incidental to or an inconsequential element of the service and not separately charged; second, the tangible personal property is the primary object of the transaction and the service is incidental to the property acquired and not separately charged; and third, the property and service are distinct and each is a consequential element of the transaction and can be readily separated. In the first, the sale is all nontaxable; in the second, the sale is all taxable; and in the third, the property, but not the service component, is taxable.

229 Ariz. at 167 ¶11 (citation omitted). The Court of Appeals found Val-Pak fell into the first scenario as the dominant purpose of Val-Pak's business was design, printing, and mailing services not the paper itself. *Id*. at 167–68 ¶14.

The Court of Appeals in *ADP* referenced these three approaches. 254 Ariz. at 424 ¶23. There, the Court of Appeals rejected ADP's argument that it fell into the first category because the property and services provided were easily separable and documented in its invoices. *Id*. at 424–25 ¶23. As referenced above, any charges for services bundled with the software rental were secondary and taxable. *Id*. at 425 ¶24. Such is the case here.

[redacted] also relies on ADOR Private Taxpayer Rulings on safe deposit box services (LR03-001, LR05-009, LR07-003), moving services that include storage space (LR04-003), and information technology that included use of a router (LR07-004). (Pl.'s Mot., at 5–6, and at its

[redacted] [redacted]

Exhs. B–D.) However, the Court does not give any weight to such rulings. *See* A.R.S. § 42-2101(F) ("A private taxpayer ruling or taxpayer information ruling may not be relied on, cited or introduced into evidence in any proceeding by a taxpayer other than the taxpayer who has received the private taxpayer ruling.")

[redacted] contends there was confusion as to the taxes on real property rental and personal property rental, and therefore the Assessment is unconstitutional and illegal. (Pl.'s Mot., at 7.) "An act which imposes a tax must be certain, clear and unambiguous, especially as to the subject of taxation and the amount of the tax." *Duhame v. State Tax Comm'n*, 65 Ariz. 268, 272 (1947) (citations omitted). Here, the Court does not find that the statutes at issue are ambiguous.

[redacted] also contends that the Department's Assessment is an unconstitutional act of legislation. (Pl.'s Mot., at 7.) [redacted] contends that the Department usurped power belonging to the Legislature by imposing tax on a new category or type of business not designated by the Legislature. (Pl.'s Mot., at 7.) The Department contends that auditing and assessing is not a legislative act. (Def.'s Resp., at 8.) In *Duhame*, the Arizona Supreme Court explained:

> [I]f under such a statute the Commission selected one of these vague, or alternate and differing bases for a taxpayer, such a selection would not only be a violation of due process of law as regards that taxpayer, but would be an unconstitutional act of legislation by a Commission to whom the power to legislate was not delegated.
>
> An excellent statement of the principle of law here involved appears in *Larabee Flour Mills Co. v. Nee, D. C.*, 12 F. Supp. 395 (remanded on another point after the United States Supreme Court in *United States v. Butler*, 297 U.S. 1, 56 S.Ct. 312, 80 L.Ed. 477, 102 A.L.R. 914 and *Rickert Rice Mills v. Fontenot*, 297 U.S. 110, 56 S.Ct. 374, 80 L.Ed. 513, held the Agricultural Adjustment Act unconstitutional). There the Court said: 'Congress cannot surrender any part of the legislative power. The Constitution vests that power exclusively in Congress. The power to tax is a legislative power. The power to tax includes the power to say what shall be taxed, who shall pay it, what the tax shall be.' 12 F. Supp. at page 402. '* * * What Congress cannot do is to delegate to an administrative official not only the power to fix a rate of taxation according to a standard, but also the power to prescribe the standard. Congress must prescribe the standard * * * an intelligible standard, a definite standard. It must be like a yardstick which is three feet long by whomsoever it is used,

[redacted] [redacted]

> not one which in the hands of one man is three feet long, in the hands of another two feet long, and in the hands of a third four feet long, elastic at the will of the individual applying it.' 12 F. Supp. at page 403.

65 Ariz. at 273–74. Here, the Court has found that the statutes at issue are not vague or ambiguous. Therefore, the Court does not find auditing and assessing under those statutes to be a legislative act. Auditing and assessing are activities that affix a rate of taxation according to a standard—not the act of prescribing the standard itself. *See Duhame*, 65 Ariz. at 274.

[redacted] argument that the tax violates Article IX § 25 of the Arizona Constitution is also unpersuasive. Article IX § 25 prohibits imposing or increasing TPT for services performed in Arizona not in effect on December 31, 2017. Ariz. Const. art. IX, § 25. [redacted] contends that TPT cannot be imposed now on colocation services, IaaS services, and ancillary services. (Pl.'s Mot., at 7–8.) The Department contends that Article IX § 25 did not eliminate taxes on real or tangible person property rentals. (Def.'s Resp., at 8.) The Department also contends that [redacted] cannot add the word "services" to create an exemption. (Def.'s Resp., at 8.)

THE COURT FINDS that the tax on [redacted] real property and server rentals does not violate Article IX § 25 because it does not impose or increase TPT on services.

[redacted] contends that the federal Internet Tax Freedom Act ("ITFA") prohibits taxation of [redacted] for real property rental and personal property rental. (Pl.'s Mot., at 8.) ITFA prohibits "Taxes on Internet access." 47 U.S.C. § 151, note (ITFA § 1101(a)(1)). Internet access "means a service that enables users to connect to the Internet to access content, information, or other services offered over the Internet[.]" ITFA § 1105(5)(A). The Department contends that servers do not access data on the internet but transmit it over the internet. (Def.'s Resp., at 9.) The Department also contends that [redacted] does not provide internet connections to all of its customers. (Def.'s Resp., at 9.)

THE COURT FINDS that the tax on [redacted] real property and server rentals does not violate the ITFA because [redacted] provides rental of real property and servers—not services to access the internet.

[redacted] contends that the Assessment violates Arizona's Taxpayer Bill of Rights because the Department seeks to retroactively apply TPT to "a new or additional category or type of taxpayer." A.R.S. § 42-2078(B). (Pl.'s Mot., at 9.) The Department contends that there is no evidence that either the state or city had any prior formal interpretation that colocation rentals and server rentals were not taxable. (Def.'s Resp., at 10.)

[redacted] [redacted]

A.R.S. § 42-2078(B) states:

> If the department adopts a new interpretation or application of any provision of this title or title 43 or determines that any of those provisions applies to a new or additional category or type of taxpayer, and the change in interpretation or application is not due to a change in the law:
>
> 1. The change in interpretation or application applies prospectively unless it is favorable to taxpayers.
>
> 2. The department shall not assess any tax, penalty or interest retroactively based on the change in interpretation or application.
>
> 3. The change is an affirmative defense in any administrative or judicial action for retroactive assessment of tax, interest and penalties to taxable periods before the new interpretation or application was adopted.

The Department's response focuses on the first part of the statute regarding "a new interpretation or application" and ignores the portion of the statute [redacted] relies on regarding the application "to a new or additional category or type of taxpayer." (Def.'s Resp., at 10.) Here, the Department has applied the real property rental tax and personal property rental tax to data centers as to colocation services and server rentals when before it had not had occasion to do so. **THE COURT FINDS that** this violates A.R.S. § 42-2078(B), and the application may only apply prospectively pursuant to A.R.S. § 42-2078(B)(1).

[redacted] contends that if it is subject to TPT, it should receive a deduction for the reimbursements [redacted] customers paid for already-taxed electricity expenses. (Pl.'s Mot., at 17.) [redacted] also contends that the penalties included in the Assessment should be abated because [redacted] had a reasonable basis to believe the tax code did not apply and timely paid taxes. ([redacted] Mot., at 17.) Given the Court's findings above, these arguments are moot.

IT IS ORDERED granting in part Defendant Arizona Department of Revenue's Motion for Summary Judgment, filed [redacted], that [redacted] is subject to the TPT applicable to the rental of real property and tangible personal property based on the colocation services and server rentals.

[redacted] [redacted]

IT IS FURTHER ORDERED granting in part Plaintiff [redacted] Motion for Summary Judgment, filed [redacted], as to the application of the TPT retroactively.

All other relief requested in the Motions is denied.

[redacted] also filed a motion seeking to exclude the testimony of Defendant's expert witness Tamal Bose, limit the opinion of Defendant's expert Kevin O'Bryan, and exclude the opinion of fact witness Lavelle Bland. ([redacted] Daubert Mot., at 1–2.) [redacted] contends that Tamal Bose is not qualified, Kevin O'Bryan is only qualified to offer opinions on leases of entire commercial data centers, and Lavelle Bland is not qualified and not timely disclosed. ([redacted] Daubert Mot., at 2.)

Given the Court's rulings above, Plaintiff's *Daubert* Motion to Exclude Testimony of Tamal Bose and Limit Testimony of Kevin O'Bryan and Lavelle Bland, filed [redacted], is deemed moot. For the record, the Court did not consider the draft declaration of Lavelle Bland in rendering these rulings, due to Plaintiff's disclosure objection, which is sustained. Therefore,

IT IS FURTHER ORDERED denying as moot Plaintiff's *Daubert* Motion to Exclude Testimony of Tamal Bose and Limit Testimony of Kevin O'Bryan and Lavelle Bland, filed [redacted].

Because the Court finds the statutory interpretation issues addressed in this ruling to be of general, public interest and likely to recur absent clear, binding legal precedent, the Court designates this ruling for publication pursuant to A.R.S. § 12-171 and Rule 16 of the Arizona Tax Court Rules of Practice. The published decision that results is not intended to operate as an appealable judgment absent further order of the Court.