DIVISION ONE
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IN THE COURT OF APPEALS
STATE OF ARIZONA
DIVISION ONE

CITY OF MESA, a political subdivision of the State of Arizona,	)	1 CA-TX 08-0010
	)	DEPARTMENT T
Plaintiff/Appellee,	)	**MEMORANDUM DECISION**
v.	)	(Not for Publication – Rule 28, Arizona Rules of Civil Appellate Procedure)
VAL-PAK EAST VALLEY, INC., an Arizona corporation,	)	
Defendant/Appellant.	)	

Appeal from the Arizona Tax Court

Cause No. TX 2006-050161

The Honorable Thomas Dunevant, III, Judge, Retired

REVERSED

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J O H N S E N, Judge

¶1 Val-Pak East Valley, Inc. ("Taxpayer") appeals from a grant of summary judgment holding it liable for use tax under Mesa City Code section 5-10-610. Because we conclude that the tax court committed legal error, we reverse the judgment.

FACTS AND PROCEDURAL BACKGROUND

¶2 Taxpayer is an Arizona corporation in the business of direct mail solicitation. Taxpayer is a franchisee of Val-Pak Direct Marketing Systems, Inc. ("Franchisor"), which is based in Florida. Taxpayer's sales representatives sell advertising to clients, including some in Mesa. The advertising consists of coupons to be sent by direct mail to potential customers of Taxpayer's clients. Under Taxpayer's contract with Franchisor, Franchisor creates the coupons, prints them, puts them into envelopes and mails them from Florida to addresses as directed by Taxpayer. Taxpayer chooses the paper on which Franchisor prints the coupons.

¶3 On September 22, 2003, the City of Mesa (the "City") assessed $51,746.38 in use taxes against Taxpayer for the period of June 1996 to July 2002. Taxpayer protested the assessment. The hearing officer held that the "dominant purpose" of the transactions between Taxpayer and Franchisor was the purchase of printing services, and the cost of the paper on which Franchisor

printed the coupons accounted for no more than 9 percent of the total invoice. He accordingly held that Taxpayer would be subject to use tax on the 9 percent of the invoiced amount.

¶4 The City filed a complaint in the Arizona Tax Court pursuant to Arizona Revised Statutes ("A.R.S.") sections 12-161 through 12-174 (2003). On cross-motions for summary judgment, the tax court entered judgment in favor of the City. This appeal followed. We have jurisdiction pursuant to A.R.S. § 12-2101(B) (2003).

DISCUSSION

A. Standard of Review.

¶5 This court reviews the tax court's grant of summary judgment *de novo*. *Wilderness World, Inc. v. Ariz. Dep't of Revenue*, 182 Ariz. 196, 198, 895 P.2d 108, 110 (1995). We likewise review *de novo* the tax court's construction of statutes and findings that combine fact and law. *Ariz. Dep't of Revenue v. Ormond Builders, Inc.*, 216 Ariz. 379, 383, ¶ 15, 166 P.3d 934, 938 (App. 2007). When necessary, we will examine the related provisions to determine the intent of the legislative body that enacted them.

B. Relevant Mesa City Code Provisions.

¶6 Section 5-10-610(A) of the Mesa City Code levies, "subject to all other provisions of this Chapter, an excise tax on the storage or use in the City of tangible personal

property." As relevant to this case, the use tax is imposed at the rate of 1.75 percent of the:

> 1. Cost of tangible personal property, except jet fuel, acquired from a retailer upon every person storing or using such property in this City.

Mesa City Code § 5-10-610(B). Another provision states that the tax is owed by "[a]ny person who acquires tangible personal property from a retailer, whether or not such retailer is located in this City, when such person stores or uses said property within the City." Mesa City Code § 5-10-620(A).

¶7 The "general definitions" section of the code defines "retailer" as "[a]ny person engaged or continuing in the business of sales of tangible personal property at retail." Mesa City Code § 5-10-100. The use tax article, Article VI, contains the following definition of retailer: "any person selling, renting, licensing for use, or leasing tangible personal property under circumstances which would render such transactions subject to the taxes imposed in Article IV if such transactions had occurred within this City." Mesa City Code § 5-10-600.

¶8 Finally, a transaction privilege tax is imposed on "job printing" under Mesa City Code § 5-10-425. This tax applies to "the gross income from the business activity upon every person engaging or continuing in the business of job

printing, which includes engraving of printing plates, embossing, copying, micrographics, and photo reproduction." Mesa City Code § 5-10-425(A).

C. Taxpayer Is Not Subject to the City's Use Tax for the Services It Acquires from Franchisor.

¶9 The parties agreed to a stay in the tax court pending this court's decision in *Qwest Dex, Inc. v. Arizona Department of Revenue*, 210 Ariz. 223, 109 P.3d 118 (App. 2005). In that case, we ruled on a levy of a use tax under state law. We adopt the same analysis in holding the City may not impose its use tax on the job printing services Taxpayer receives from Franchisor.

¶10 In *Qwest Dex*, the taxpayer was in the business of publishing telephone directories and contracted with out-of-state printing companies to print the directories. 210 Ariz. at 224, ¶ 2, 109 P.3d at 119. The taxpayer contracted separately for the paper on which the directories were printed. *Id.* It asserted it owed a use tax only on the paper that went into the directories, not for the printing of the directories. *Id.* at 225, ¶ 6, 109 P.3d at 120. The tax provision at issue was A.R.S. § 42-5155(A) (2006), which levies a use tax "on the storage, use or consumption in this state of tangible personal property purchased from a retailer or utility business, as a percentage of the sales price."

¶11 Applying two alternative analyses, this court in *Qwest Dex* agreed that the printing services provided by the out-of-state printers were not subject to Arizona's use tax. 210 Ariz. at 226, ¶ 16, 109 P.3d at 121. Applying the same analyses to the facts presented here, we come to the same conclusion.

1. The "dominant purpose" test.

¶12 The *Qwest Dex* court first applied the "dominant purpose" test. *Id.* (citing *Goodyear Aircraft Corp. v. Ariz. State Tax Comm'n*, 1 Ariz. App. 302, 402 P.2d 423 (1965)). Under this test, "if the dominant purpose of the transaction is a service, then the transaction is not taxable." 210 Ariz. at 226, ¶ 17, 109 P.3d at 121, (citing Jerome R. Hellerstein & Walter Hellerstein, *Sales and Use, Personal Income, and Death and Gift Taxes and Intergovernmental Immunities in State Taxation*, ¶ 12.08, at 78 (3d ed. 2001-2003)).

¶13 We explained:

> When there is a fixed and ascertainable relationship between the value of the article and the value of the service rendered in connection therewith so that both may be separately stated, then the vendor is engaged in both selling at retail and furnishing services and is subject to the tax as to one and tax exempt as to the other. Where the property and the services are distinct and each is a consequential element capable of ready separation, it cannot be said one is an inconsequential element within the exemption provided by the statute.

210 Ariz. at 227, ¶ 18, 109 P.3d at 122 (quoting *Goodyear*, 1 Ariz. App. at 306, 402 P.2d at 427). Applying this test, we noted that the taxpayer purchased the paper from another source and paid for it separately, *id.*, ¶ 20, and that the cost of the paper was inconsequential to the cost of printing the directories. *Id.* at 227-28, ¶¶ 20, 22, 109 P.3d at 122-23; *see also State Tax Comm'n v. Holmes & Narver, Inc.*, 113 Ariz. 165, 167-69, 548 P.2d 1162, 1164-66 (1976) (taxpayer was liable for a transaction privilege tax on construction costs but not on the separately itemized, out-of-state design services); *see generally* Ariz. Admin. Code R15-5-104(C)(1) (providing that sales of tangible personal property shall be considered an inconsequential element of a service if the "purchase price of the tangible personal property to the person rendering the services represents less than 15% of the charge, billing, or statement rendered to the purchaser in connection with the transaction").

¶14 The same is true here. The City conceded and the hearing officer found that the cost of paper accounted for only 9 percent of the amount of the invoices Franchisor sent to Taxpayer. Under this analysis, the dominant purpose of the transaction was job printing, a service, not the purchase of tangible personal property. *See Qwest Dex*, 210 Ariz. at 227-28, ¶¶ 20, 22, 109 P.3d at 122-23.

¶15 As the hearing officer noted, while the taxpayer in *Qwest Dex* bought the paper separately and provided it to the job printer, Taxpayer's contract with Franchisor did not require it to separately provide or contract for the paper on which the coupons were to be printed. We agree with the hearing officer's conclusion that the distinction does not compel a different outcome. The important point for this analysis is that the value of the paper can be segregated from the value of the job printing services Franchisor provided – its creation of the design of the coupons, its printing of the coupons and the related mailing services it provided Taxpayer.

2. The common understanding test.

¶16 The *Qwest Dex* court explained that what it termed the "common understanding" test is an alternative means of analyzing whether a transaction may be subject to use tax. *Id.* at 228, ¶ 23, 109 P.3d at 123. Under this analysis, "whether a transaction qualifies as the sale of tangible personal property or the sale of a service is determined by the parties' common understanding of the particular trade, business, or occupation." *Id.*

¶17 Applying this test, the *Qwest Dex* court found that the printing of the telephone directories for the taxpayer constituted a service rather than tangible personal property. *Id.* at 229, ¶ 24, 109 P.3d at 124. It explained, "Few would

dispute that the Printers provided a service to Taxpayer in agreeing to print the directories. Indeed, the very nature of the term 'printing' denotes a service and not a tangible item." *Id.* (citing *H.G. Adair Printing Co. v. Ames*, 4 N.E.2d 481, 481 (Ill. 1936)); s*ee Comty. Telecasting Serv. v. Johnson*, 220 A.2d 500 (Me. 1966) (pamphlets sold to television stations containing market survey results constituted a service and were not subject to the use tax); *Dun & Bradstreet v. City of New York*, 276 N.Y. 198, 205 (1937) (telephone company renders a service by furnishing books containing telephone numbers: "The paper is a mere incident; the skilled service is that which is required.").

¶18 Under the same principles, we conclude Taxpayer contracted with Franchisor for the service of job printing. The coupons that Franchisor produced contained advertising that it created and printed specifically on Taxpayer's order for Taxpayer's clients. Beyond the creation and printing of the coupons, Franchisor also provided the additional service of packing the coupons into envelopes and mailing them to addresses specified by Taxpayer. For these reasons, we conclude that the "common understanding" of this transaction is that Taxpayer and Franchisor contracted for a service, not an item of tangible personal property.[1]

[1] As noted, the hearing officer ruled Taxpayer would be subject to the City's use tax on the 9 percent invoice amount

¶19 The City nevertheless contends that this case is controlled by *Service Merchandise Co. v. Arizona Department of Revenue*, 188 Ariz. 414, 937 P.2d 336 (App. 1996). In *Service Merchandise*, this court held a taxpayer was subject to a use tax on the price it paid for the production of catalogs and fliers it ordered for distribution to customers in Arizona. *Id.* at 416-18, 937 P.2d at 338-40. We did not address in that case, however, the issue we conclude is dispositive here, namely, whether the printing and distribution of the catalogs constituted job printing services or tangible personal property. *See Qwest Dex*, 210 Ariz. at 230, ¶¶ 32-33, 109 P.3d at 125.[2]

3. Whether the service would be taxed if performed in Mesa.

¶20 Notwithstanding the City's argument, it is not relevant to our analysis that Franchisor would have been taxed as a job printer had it been located in Mesa. As we explained in *Qwest Dex*:

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stipulated to represent the cost of the paper on which the coupons were printed. On appeal, Taxpayer does not take issue with that ruling.

[2] The City also invokes *ADVO Sys., Inc. v. City of Phoenix*, 189 Ariz. 355, 942 P.2d 1187 (App. 1997). Its reliance on that case is misplaced. The issue in *ADVO* was the application of an advertising transaction privilege tax. We rejected the taxpayer's argument that it owed no tax on sums it paid in job printing taxes or use taxes it paid on job printing. *Id.* at 363, 942 P.2d at 1195. There is no indication in the decision that, as here, the taxpayer disputed whether a use tax was owed in the first place, and we did not address that issue.

> This varying treatment does not change our conclusion as to the use tax here. The job printing classification, unlike the use tax, specifically includes a provision for such a tax on job printing. Arizona's use tax, in contrast, imposes no specific tax on printing services. We must construe the tax statute strictly against the state and resolve any ambiguities in favor of the taxpayer. *See Wilderness World, Inc.*, 182 Ariz. at 199, 895 P.2d at 111. In the absence of a legislative amendment imposing a tax on out-of-state printing, we will not impose such a tax on the printing services provided to Taxpayer.

210 Ariz. at 229, ¶ 26, 109 P.3d at 124. Although the City's code imposes a privilege tax on job printing performed within the city limits, it does not include job printing within its use-tax provision, and we decline to permit the imposition of such a tax without a provision in the code.

4. Mesa tax code provisions do not change the outcome.

¶21 The City argues that different provisions in its tax code compel a different result than we reached in *Qwest Dex*. As noted, the City's use tax is payable by "[a]ny person who acquires tangible personal property from a retailer . . . when such person stores or uses said property within the City." Mesa City Code § 5-10-620(A). The City argues that Franchisor is a "retailer" pursuant to City Code § 5-10-600 because it sells paper as part of its printing business. It argues Taxpayer therefore is liable for use tax because it acquired tangible

personal property from a "retailer" under Mesa City Code § 5-10-620(A).[3]

¶22 The City's proposed construction of these provisions is inconsistent, however, with two other provisions, Mesa City Code §§ 5-10-460 and 5-10-465, which also appear in Article IV of the City's tax code. Section 5-10-460 provides:

> (A) The tax rate shall be at an amount equal to one and three-fourths percent (1.75%) of the gross income from the business activity upon every person engaging or continuing in the business of selling tangible personal property at retail.
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> * * *
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> (C) Exclusions. For the purposes of this Chapter, sales of tangible personal property shall not include:
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> * * *
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> 5. Sales by professional or personal service occupations where such sales are inconsequential elements of the service provided.

To the extent that the job printing Franchisor performs for Taxpayer includes the sale of paper, it is inconsequential and therefore not "tangible personal property" within the meaning of § 5-10-460(C)(5). It follows that Franchisor is not a "retailer" for purposes of the code because it is not selling

[3] The tax court based its analysis on a "sale for resale" exception in the job printing transaction privilege tax provision, Mesa City Code § 5-10-425. Because on appeal neither party urges us to adopt that reasoning, we do not address it.

tangible personal property within the meaning of the code. *See id.*

CONCLUSION

¶23 For the reasons set forth above, we hold Taxpayer is not liable for the City's use tax on the 91 percent of the invoiced amounts not attributable to the cost of paper. Therefore, we reverse the tax court's grant of summary judgment. On remand, the tax court shall enter summary judgment in favor of Taxpayer. In addition, we award Taxpayer its reasonable attorney's fees on appeal pursuant to A.R.S. § 12-348(B)(1)(2003) and subject to its compliance with Rule 21(C) of the Arizona Rules of Civil Appellate Procedure.

/s/
DIANE M. JOHNSEN, Presiding Judge

CONCURRING:

/s/
MAURICE PORTLEY, Judge

/s/
DANIEL A. BARKER, Judge