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ARIZONA TRANSACTION PRIVILEGE TAX PROCEDURE
TPP 18-1

ISSUE:

This procedure provides guidance on qualifying for the deduction under the utilities classification for sales of electricity or natural gas to manufacturing or smelting operations.

APPLICABLE LAW:

Arizona Revised Statute (A.R.S.) § 42-5063 imposes the transaction privilege tax under the utilities classification. The tax base for the classification is the gross proceeds of sales or gross income derived from the business.

A.R.S. § 42-5063(C)(6) allows a deduction from the tax base for gross proceeds of sales or gross income derived from sales of electricity or natural gas to a qualified manufacturing or smelting business.

A.R.S. 42-5063(C)(6)(a) provides the term "gas transportation services" means the services of transporting natural gas to a natural gas customer or to a natural gas distribution facility if the natural gas was purchased from a supplier other than the utility.

A.R.S. § 42-5063(C)(6)(b) provides that the term “manufacturing” means the performance as a business of an integrated series of operations that places tangible personal property in a form, composition or character different from that in which it was acquired and transforms it into a different product with a distinctive name, character or use. Manufacturing does not include job printing, publishing, packaging, mining, generating electricity or operating a restaurant.

A.R.S. § 42-5063(C)(6)(d) provides the term “smelting” means to melt or fuse a metalliferous mineral, often with an accompanying chemical change, usually to separate the metal.

A.R.S. § 42-5009 provides the requirements for establishing deductions from the tax base which are allowable pursuant to statutory provisions.

<u>BACKGROUND</u>:

Arizona imposes a transaction privilege tax that differs from the sales tax imposed by most states. The Arizona transaction privilege tax is a tax imposed on the privilege of conducting business in the State of Arizona. The tax is levied on the <u>vendor</u>, not the purchaser. The vendor may pass the burden of the tax on to the purchaser; however the vendor is the party that is ultimately liable to Arizona for the tax. The transaction privilege tax is imposed under sixteen separate business activity classifications.

A.R.S. § 42-5063, imposes the transaction privilege tax under the utilities classification. The utilities classification is comprised of the business of:

1. Producing and furnishing or furnishing to consumers natural or artificial gas and water.
2. Providing to retail electric customers ancillary services, electric distribution services, electric generation services, electric transmission services and other services related to providing electricity.

<u>PROCEDURE:</u>

1. Procedure to Determine Whether a Business is a Manufacturing or Smelting Operation

Smelting means to melt or fuse a metalliferous mineral, often with an accompanying chemical change, usually to separate the metal. Manufacturing means the performance as a business of an integrated series of operations that places tangible personal property in a form, composition or character different from that in which it was acquired and transforms it into a different product with a distinctive name, character or use. Examples of manufacturing include a company that turns wood pulp into toilet paper and a company that casts metal.

The statutory definition also specifically excludes other activities from manufacturing: job printing, publishing, packaging, mining, generating electricity or operating a restaurant. If the business engages in an activity that is commonly understood to be manufacturing as defined it is more likely to qualify as a manufacturing operation. For example, a business engaged in activities that, when viewed in isolation, may be considered manufacturing will nevertheless not constitute a manufacturing operation if it is commonly considered or generally understood to be a restaurant operation.

2. Procedure to Determine Whether a Manufacturing Business is a Qualified Manufacturing or Smelting Business

After a purchaser has determined it has manufacturing or smelting activities then it must determine if it is a *qualified* manufacturing or smelting business. "Business" means a business with a transaction privilege tax license[1] for operations that includes manufacturing or smelting including all locations associated with the licensed manufacturing or smelting business in Arizona.

Under A.R.S. § 42-5063(C)(6)(c) a business is a qualified manufacturing or smelting business[2] if it satisfies one of the following:

(i) it manufactures or smelts tangible products in this state and at least fifty-one percent of the manufactured or smelted products will be exported out of state for incorporation into another product or sold out of state for a final sale.

(ii) it derives at least fifty-one percent of its gross income from the sale of manufactured or smelted products manufactured or smelted by the business.

(iii) it uses at least fifty-one percent of its square footage in this state for manufacturing or smelting and business activities directly related to manufacturing or smelting.

(iv) it employs at least fifty-one percent of its workforce in this state in manufacturing or smelting and business activities directly related to manufacturing or smelting.

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[1] Manufacturers are required to obtain transaction privilege tax licenses.

[2] A.R.S. § 42-6013 permits a city to either impose or exempt the sale of utilities to a manufacturing or smelting business in a similar manner to the state. Please consult the Model City Tax Code ("MCTC") to determine whether a city has adopted this deduction. The MCTC is available online at modelcitytaxcode.az.gov/.

(v) it uses at least fifty-one percent of the value of its capitalized assets in this state, as reflected on the business's books and records, for manufacturing or smelting and business activities directly related to manufacturing or smelting.

Products Manufactured or Smelted for Export or Sale outside Arizona

At least 51% of the purchaser's products manufactured or smelted in Arizona must be exported to be incorporated into other products or sold outside Arizona to qualify under this subdivision of the deduction. For the purposes of determining products exported, a one-year period is required. Businesses in operation for less than one year may project the anticipated value of products to be exported. If the business projects a certain value of exported products and does not meet its projection then it would not qualify for the deduction going forward.

Revenue

In order to qualify under this subdivision of the deduction, at least 51% of the purchaser's revenues must be derived from its manufacturing or smelting operation in Arizona. If a purchaser has no revenue, this subdivision is inapplicable. For the purposes of determining revenue, a one-year period is required. All revenue from all Arizona locations associated with the business's transaction privilege tax license must be included in the calculation. Businesses in operation for less than one year may project their anticipated revenue. If the business projects revenue and does not meet its projection then it would not qualify for the deduction in subsequent years.

Value of Capitalized Assets

In order to qualify under this subdivision of the deduction, at least 51% of the value of the business's capitalized assets must be included in its manufacturing or smelting operation in Arizona. It includes all assets at all locations associated with the business's transaction privilege tax license. For the purposes of determining value of capitalized assets, the value of the assets in Arizona, as reflected on the business's books and records on December 31st of the prior year shall be utilized to determine the percentage used in manufacturing or smelting.

<u>Head Count and Square Footage</u>

In determining head count and square footage, not all administrative staff, facilities, or support staff is considered directly related to manufacturing or smelting. Examples of administrative staff, facilities, or support staff that would be considered *directly* related to manufacturing or smelting are manufacturing technicians/operators, manufacturing supervisor, and line/assembly operators. Examples of administrative staff, facilities, or support staff that would **NOT** be considered directly related to manufacturing or smelting are accountants, research and development staff/facilities, cleaning staff/facilities, the Chief Financial Officer, and sales personnel/facilities.

Head count refers to the number employees of the business and includes all employees at all locations associated with the business's transaction privilege tax license in Arizona. The percentage of employees in Arizona directly related to manufacturing or smelting must be at least 51% to qualify for this subdivision of the deduction. For the purposes of determining head count, the number of employees in Arizona on December 31st of the prior year shall be utilized to determine the percentage used in manufacturing or smelting.

The percentage of square footage in Arizona directly related to manufacturing or smelting must be at least 51% to qualify for this subdivision of the deduction. For the purposes of determining square footage, all square footage at all the business's locations in Arizona associated with its transaction privilege tax license must be included. The square footage of the Arizona business on December 31st of the prior year shall be utilized to determine the percentage used in manufacturing or smelting.

3. Worksheet for figuring the percentage of business that is a manufacturing or smelting operation

Complete the *Worksheet for figuring the percentage of business that is a manufacturing or smelting operation* to help determine if at least fifty-one percent of the business qualifies as a manufacturing or smelting operation. If the information is not available to complete the worksheet for a criteria mark the row as N/A. This will not disqualify the business from the deduction as long as it can qualify for one of the subdivisions of the deduction. If the business completes the worksheet for any given tax year, it should keep a copy of the completed worksheet along with any documentation it may have establishing that at least 51% of the business is a manufacturing or smelting operation.

All locations associated with the manufacturing or smelting business's transaction privilege tax license must be included in the calculations.

1.	Total value of manufactured/smelted products exported out of Arizona	
2.	Total value of products manufactured/smelted in Arizona	
3.	**Divide line 1 by line 2. This is percentage of the licensed business's products exported out of Arizona.**	%
4.	Revenues received from manufacturing/smelting in Arizona	$
5.	Gross revenues from business in Arizona	$
6.	**Divide line 4 by line 5. This is percentage of revenue from the licensed business's manufacturing/smelting operations in Arizona.**	**%**
7.	Number of employees engaged in manufacturing/smelting in Arizona.	
8.	Total number of employees in Arizona.	
9.	**Divide line 7 by line 8. This is the percentage of the licensed business's employees engaged in manufacturing/smelting in Arizona.**	**%**
10.	Businesses value of capitalized assets used directly in manufacturing/smelting in Arizona.	$
11.	Businesses overall value of capitalized assets in Arizona.	$
12.	**Divide line 10 by line 11. This is the percentage of the licensed business's value of capitalized assets used in manufacturing/smelting in Arizona.**	**%**
13.	Square footage of floor space of business in Arizona dedicated to manufacturing/smelting	
14.	Total square footage of business in Arizona	
15.	**Divide line 13 by line 14. This is the percentage of licensed business's floor space dedicated to manufacturing/smelting in Arizona**	**%**

4. Procedure for Documenting Deductions under A.R.S. § 42-5009(A)

If after analysis, the manufacturer or smelter determines that it is a qualified manufacturing or smelting business, the manufacturer or smelter would then provide a certificate to the vendor, citing the basis for the deduction. The department has issued a general exemption certificate, Arizona Form 5000, to be used in documenting that a transaction is not subject to transaction privilege tax. The Form 5000 is the valid certificate to be used to document this deduction.

1) The sales invoice must be marked to indicate that the amount of the sale was deducted from the tax base; and,

2) A properly completed Form 5000 must be on file with the utility company that indicates:

- Name and address of the purchaser;
- Precise nature of the purchaser's business;
- Purpose for which the purchase was made;
- The purchaser's transaction privilege tax license number.

The Form 5000 must be signed by a person authorized to sign on behalf of or as representative for the purchaser. The box should be checked for the specific utility deduction for manufacturers and smelters. Additionally, the utility account numbers that qualify for the deduction must be indicated on the form or as an attached addendum.

Pursuant to A.R.S. § 42-5009(C), the Department of Revenue has adopted certificates to comply with A.R.S. § 42-5009(A). Under A.R.S. § 42-5009(D), if a vendor accepts the certificate adopted by the department and it is completed pursuant to statutory requirements, the **vendor** will be relieved of any tax liability and the department may require the **purchaser** to establish the accuracy and completeness of the claimed deduction or exemption. If the **purchaser** is required to establish the accuracy and completeness of the information, but is unable to do so, the purchaser is liable in an amount equal to any tax, penalty, and interest that the vendor would have been required to pay as transaction privilege tax if the vendor had not complied with A.R.S. § 42-5009(A).

The department may require the **vendor** to establish the accuracy of the information provided on a departmental certificate (Form 5000) if it has reason to believe that the vendor did not act in *good faith* in accepting the certificate. ***Good faith*** means honesty of intention and freedom from knowledge of circumstances that should cause the vendor to deny the claimed deduction or exemption.

Grant Nülle, Deputy Director

Signed: November 8, 2018

Explanatory Notice

The purpose of a tax procedure is to provide procedural guidance to the general public and to Department personnel. A tax procedure is a written statement issued by the Department to assist in the implementation of tax laws, administrative rules, and tax rulings by delineating procedures to be followed in order to achieve compliance with the law. Relevant statute, case law, or administrative rules, as well as a subsequent procedure, may modify or negate any or all of the provisions of any tax procedure. See GTP 96-1 for more detailed information regarding documents issued by the Department of Revenue.