

# STATE OF ARIZONA

Department of Revenue



Janice K. Brewer  
Governor

John A. Greene  
Director

December 15, 2011

Attached please find a copy of a proposed Arizona Transaction Privilege Tax Ruling addressing the prime contracting classification for transaction privilege tax. In an ongoing effort to interact with and inform the public on issues relating to taxation, the Department would appreciate your written comments on this draft.

Please be advised that the deadline for comments is **Friday, February 10, 2012**. Any request for an extension of time for review must be made by this date. This office will review all comments that are received through this date and make any appropriate revisions before the Department issues the final ruling.

Please address your comments to:

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Thank you for your continuing efforts in maintaining an ongoing line of communication with our agency.

Sincerely,

/s/ Hsin Pai  
Tax Analyst  
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Attachments



Janice K. Brewer
Governor

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ARIZONA TRANSACTION PRIVILEGE TAX RULING
TPR 11-\_\_

DRAFT 12/15/11—FOR REVIEW AND COMMENT PURPOSES ONLY

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PREFACE AND PURPOSE:

Before September 2011, Arizona Administrative Code ("A.A.C.") Title 15, Chapter 5, Article 6 contained thirteen administrative rules for Arizona transaction privilege tax ("TPT") levied under the prime contracting classification, which is found at Arizona Revised Statutes ("A.R.S.") § 42-5075. Although some of the rule language dated back to the late 1970s, the Legislature made numerous revisions to the underlying statute over this period. Consequently, where not erroneous per se, the language of the contracting rules was often overly conclusory, given the increased complexity of and changes within the contracting industry. The lack of additional explanation or context in the rules, moreover, led those who consulted them to arrive at positions contrary to A.R.S. § 42-5075, resulting in difficulties for both compliance and enforcement of the tax. In consideration of the shortcomings of the administrative rules and lack of current guidance on the law, the Department has allowed twelve of the thirteen rules to expire and issues this ruling to provide the public with a more comprehensive understanding of its position and interpretation of the prime contracting tax statute.

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This ruling will broadly cover the subjects addressed by the former prime contracting rules, after providing a discussion of the framework within which the TPT on prime contracting operates. Because of the numerous deductions and exclusions contained in A.R.S. § 42-5075, the ruling discusses specific deductions or exclusions only to the extent necessary to address subjects that the former rules covered. Please refer to other published rulings for more detailed discussions of these provisions, or private taxpayer rulings and taxpayer information rulings for application of the language to particular taxpayers' facts and circumstances.

While other exclusions, exemptions, or deductions may be relevant, the examples provided in this ruling incorporate the concepts discussed below as they specifically relate to the A.R.S. § 42-5075 prime contracting classification and to activities mentioned in pre-September 2011 administrative rules.

Note: For purposes of this ruling, "Job" will refer to a particular task or piece of work that a contractor performs. "Project" will collectively refer to any of the undertakings on which a prime contractor might perform modifications. A Project includes "any building, highway, road, railroad, excavation, manufactured building or other structure, project, development or improvement."<sup>1</sup> A Project can involve one or more Jobs, and similarly, one or multiple Projects can be found on any given real property or worksite.

## **ISSUES:**

This ruling will address the following subjects:

1. What is prime contracting;
2. What is the tax base for prime contracting;
3. Who is a prime contractor, for TPT purposes; and
4. What are examples of taxable modification activities under A.R.S. § 42-5075.

## **RULING:**

1. The prime contracting classification for TPT is comprised of the business of prime contracting.<sup>2</sup> Prime contracting involves the performance, supervision, or coordination of a modification to any Project, directly or by and through others. A modification includes any of the following activities:

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<sup>1</sup> A.R.S. § 42-5075(O)(2).

<sup>2</sup> A.R.S. § 42-5075(A). The classification also includes the business of dealership of manufactured buildings. That portion of the classification is not discussed in this Ruling.

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- a. An addition, which refers to an installation or other application of tangible personal property to real property that, upon installation or application, loses its character as tangible personal property and becomes part of (*i.e.*, by augmenting or uniting with) the real property.
  - b. An alteration, which is an activity that causes some physical change to the property without changing the identity of the real property.
  - c. A repair, which is an activity that returns the real property or fixture acted upon to a usable state from a partial or total state of inoperability or nonfunctionality, thereby restoring the property or fixture. Such activity may involve, but does not require, a transfer of tangible personal property.
2. The tax base for the prime contracting classification is sixty-five percent of the gross receipts from the business.<sup>3</sup> As prime contracting TPT is fundamentally a tax on service activities, no transfer of tangible personal property is necessary to incur liability for the tax, and there is no blanket exemption for labor. Any deductions, exemptions, or exclusions from TPT must be specifically set forth in statute under the prime contracting classification. Deductions, exemptions, and exclusions from another TPT classification do not apply unless expressly incorporated into the prime contracting statute.

TPT is levied on the prime contractor, even though the contractor may pass the economic burden of the tax on to its customers. There are no general exclusions under the prime contracting classification for a prime contractor's gross receipts from modifications performed for federal or state governments (or any of their agencies, instrumentalities, or political subdivisions), religious organizations, nonprofit charitable organizations, or schools.

A prime contractor is not entitled to a credit for taxes paid by another person. For example, a prime contractor cannot be credited for tax that a retailer paid for the materials it sold to the prime contractor. Also, a prime contractor may not deduct amounts attributable to its costs of doing business. A contractor may generally avoid being charged the amount for retail TPT by the retailer on materials that the contractor will later incorporate into real property by providing a retailer with a TPT Exemption Certificate (Arizona Form 5000).

TPT is measured by the gross receipts of a business. The prime contractor is subject to prime contracting TPT on all of its non-exempt receipts unless it shows that it engages in a separate line of business for a particular service or activity. The contractor can demonstrate a separate line of business if three conditions are met:

- a. The portion of the business that is the service or activity at issue can be readily calculated without substantial difficulty;

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<sup>3</sup> A.R.S. § 42-5075(B).

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- b. The revenues from the service or activity at issue, relative to the taxable revenues of the prime contracting business, are not inconsequential or minimal; and
- c. The service or activity is not incidental or integral to the prime contracting business.

If a business derives most of its gross receipts from its retail business activities but derives some receipts from performing or coordinating taxable modifications as defined by A.R.S. § 42-5075(O)(5), it can report and remit prime contracting TPT on its receipts from the modification activities without showing it engages in a separate line of business, assuming that the receipts are separately stated in the business's books and records. If the business fails to maintain proper books and records, all of its gross receipts will be subject to the higher, retail TPT rate.

A.R.S. § 42-5075(B)(9) provides a deduction for the purchase price of tangible personal property that is exempt under various, specifically enumerated retail TPT deductions or use tax exemptions. The purchase price is the price that a prime contractor paid to acquire the property at issue, not the amount that the contractor subsequently charges customers for the same property.

A.R.S. § 42-5075(B)(7) provides a separate deduction for certain activities performed in connection with such exempt property. Under the provision, if a prime contractor installs, assembles, repairs, or maintains the exempt property and the property is not permanently attached to the real property, the applicable prime contracting gross receipts are deductible. To qualify as a permanent attachment, the item in question must meet one or more of the following three conditions:

- a. It must be incorporated into the real property, such that it is combined into or imbedded in the real property so as to be made part of the real property.
- b. It must be considered reasonably belonging to or part of the real estate on which it is located, or meet all three of the following conditions:
  - 1) the item must be annexed to the realty or something appurtenant thereto;
  - 2) the item must have adaptability or application as affixed to the use for which the real estate is appropriated; and
  - 3) there must be an intention of the party to make the chattel a permanent accession to the freehold. Generally, the Department will look to objective indicia of intent when making this determination.
- c. It must become so attached to real property that removal would cause substantial damage to the real property from which it is removed. Substantial damage includes damage such that subsequent corrective or remediation action would have to be taken to return the property to a substantially similar condition as existed before removal, regardless of whether such corrective or remediation action is actually taken.

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A.R.S. § 42-5075(B)(7) does not exempt receipts from modifications to the real property or Project made to prepare for or facilitate installation, assembly, repair, or maintenance of the tangible personal property.

3. A prime contractor is any contractor who supervises, performs or coordinates the modification. The term "prime contractor" is not synonymous with "general contractor." A prime contractor does not have to be responsible for completion of an entire Project. Rather, it merely needs to be responsible for completion of modifications set forth in its contract.

*Subcontracting activities:* All contractors are generally presumed to be taxable prime contractors. Some receipts of a contractor may be deductible from prime contracting TPT when they arise from qualifying subcontracting activities. The contractor bears the burden of proof to show that:

- a. the contractor performed a Job on a Project that was under the control of a prime contractor;
- b. the prime contractor is liable for the tax on the gross receipts attributable to the Project; and
- c. the prime contractor paid the subcontractor out of those taxable gross receipts from the Project.

Contractors who timely receive a fully completed Prime Contractor's Certificate (Arizona Form 5005) in good faith will not be required to pay TPT on their gross receipts from a Job, regardless of whether they would otherwise be considered prime contractors under A.R.S. § 42-5075. Parties assuming liability as prime contractors by executing an Arizona Form 5005, however, are liable for and must remit TPT. If the party executing the Arizona Form 5005 is not a prime contractor, it must pay the amount of tax that the person receiving the certificate would have been liable for and must make the payment at the time that the TPT liability would otherwise have been paid. The use of a certificate other than the Arizona Form 5005 is not effective to make such a designation. Certificates that have been altered by parties receiving the certificates are invalid.

For a contractor's receipts to be considered derived from qualifying subcontracting activities, the contractor must work for a party that is subject to TPT on receipts from the work under the prime contracting classification rather than another tax classification (e.g., telecommunications, utilities).

Prime contractors who also own the underlying real property are liable for tax under the prime contracting classification if they receive payment to supervise, perform or coordinate modifications to the real property. The tax should not be reported under the owner builder classification set forth in A.R.S. § 42-5076.

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A developer or someone who intends to market the property and hire others to do all of the actual contracting work is not a prime contractor. A.R.S. § 42-5075(O)(8) excludes from definition of a prime contractor those real property owners who engage one or more contractors to modify their real property and who do not themselves modify the real property, regardless of the existence of a contract for sale or the subsequent sale of the real property. The exclusion does not apply if a real property owner provides contractors modifying a Project with an Arizona Form 5005, assuming liability for payment of TPT on the Project. In such a case, the owner is liable for TPT in the amounts that would otherwise be remitted by the parties for whom the owner assumes liability. Likewise, the exclusion does not apply if a real property owner enters into a contract for sale of the real property, is responsible to the purchaser for modifications to the property in the period subsequent to the transfer of title, and receives a consideration for the modifications. The actual modifications need not be directly performed by the seller for liability to attach. Prime contracting TPT would be imposed on the gross receipts the seller receives for the modifications made subsequent to the transfer of title.

Real property owners who perform some or all of the modifications themselves on Projects on behalf of third parties would generally be considered prime contractors and subject to tax on their gross receipts.

4. The following are examples of prime contracting activities:

*Handymen:* Exemption from licensure by the Arizona Registrar of Contractors ("ROC") does not mean that a person is exempt from TPT as a prime contractor. The same analysis for contractors generally must be performed to determine whether that person's gross receipts are subject to TPT under A.R.S. § 42-5075.

*Labor-only contracting:* Prime contractors that do not furnish tangible personal property are still taxable on their gross receipts from modification activities.

*Earthmoving activities:* The expired rules regarding various earthmoving, agricultural, and related activities have been superseded by A.R.S. § 42-5075(H) and (I) addressing landscaping and land maintenance activities.

*Construction managers.* Construction managers—contractors that use their experience and knowledge to manage construction sites for property owners—are generally prime contractors, and therefore liable for TPT on fees for their services. Construction managers that enter into contracts directly with trade contractors are subject to tax on the amounts paid to the trade contractors, regardless of whether the payments come from property owners. If construction managers do not enter into contracts directly with the trade contractors (e.g., the trade contractors contract with the property owner), they

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are not subject to tax on the amounts paid to the trade contractors; rather, the individual trade contractors are the prime contractors and subject to TPT on their receipts from the Project.

*Trade contractors performing offsite improvements.* Generally, trade contractors that construct offsite improvements will be considered the prime contractors for the offsite improvements rather than the property owners of the new developments.

## **DISCUSSION**

Unlike the sales tax imposed by many other states, Arizona imposes a TPT on the privilege of conducting business in the State of Arizona.<sup>4</sup> State TPT is imposed under sixteen different business classifications, including the retail and prime contracting classifications.

### **What is Prime Contracting**

By statute, taxable contracting activities include modifications accomplished through the work of a contractor's employees or through the coordination of work by subcontractors or others. In the prime contracting context, a "modification" is "construction, alteration, repair, addition, subtraction, improvement, movement, wreckage or demolition."<sup>5</sup>

The terms "alteration," "repair," and "addition" are not defined in statute. As a general rule of statutory construction, courts will consult an established and widely used dictionary to determine the common and ordinary meaning of such undefined words.<sup>6</sup> Consequently, considering the definition of each term is helpful in determining whether a taxpayer's business activities constitute contracting under one or more of these enumerated types of work. In so doing, the importance of considering these activities individually becomes apparent, as some work that might not intuitively be considered "contracting activities" by some are nevertheless encompassed within the statute.

Based on an understanding of the common and ordinary meanings of these undefined terms:

- An addition refers to an installation or other application of tangible personal property to real property that, upon installation or application, loses its character as tangible personal property and becomes part of (i.e., by augmenting or uniting with) the real property. Examples of additions to real property might include house painting;

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<sup>4</sup> A.R.S. § 42-5008.

<sup>5</sup> A.R.S. § 42-5075(O)(5).

<sup>6</sup> See, e.g., *United Dairymen of Ariz. v. Rawlings*, 217 Ariz. 592, 596, 177 P.3d 334, 338 (Ct. App. 2008).

<sup>10</sup> *Trico Elec. Coop., Inc. v. State Tax Comm'n*, 79 Ariz. 293, 297, 288 P.2d 782, 784 (1955).

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termite and preconstruction pest control treatment; and installation of cabinetry, carpeting, or wired alarm systems.

- An alteration, as used in the context of real property, is an activity that causes some physical change to the property without changing the identity of the real property. Examples might include refinishing hardwood floors, rekeying door locks (e.g., by replacing a cylinder or reconfiguring tumblers), sandblasting a building's façade, or tamping railroad ties.
- In the context of the prime contracting classification, a repair, in its general sense, is a modification if a contractor performs it on a Project. Not every activity, by virtue of "fixing" or "maintaining" an item in a general sense, constitutes "repairing" it for the purposes of performing a *taxable* modification under the prime contracting classification. Rather, a taxable repair must be an activity that returns the property to a usable state from a partial or total state of inoperability or nonfunctionality, thereby restoring the property. Such activity may involve, but does not require, a transfer of tangible personal property. Examples of taxable repair activities might include the replacement of expendable hardware (e.g., gaskets, washers) and drain clearing services.

Regarding activities that do not rise to the level of repairing or otherwise modifying real property, the gross receipts derived from them may still fall within the scope of a prime contractor's taxable gross receipts "[i]f activities are incidental in the sense that they are inseparable from the principal business and interwoven in the operation thereof to the extent that they are in effect an essential part of the major business" of prime contracting.<sup>10</sup>

While permanently attaching tangible personal property may constitute contracting, it is not an essential or required condition for it.<sup>11</sup> The modification may be made to any building, highway, road, railroad, excavation, manufactured building or other structure, project, development or improvement.<sup>12</sup> The modification can also be to any part of a Project. For example, the erection of scaffolding or other temporary structure in connection with a Project is contracting.<sup>13</sup>

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<sup>11</sup> *Brink Elec. Constr. Co. v. Ariz. Dep't of Revenue*, 184 Ariz. 354, 361, 909 P.2d 421, 428 (Ct. App. 1995) (permanent attachment is not the "sine qua non" of contracting).

<sup>12</sup> A.R.S. § 42-5075(O)(8). As noted in the preface above, this ruling refers to the items in this list collectively as "Projects."

<sup>13</sup> A.R.S. § 42-5075(O)(2).

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## Taxability of a Prime Contractor's Gross Receipts

### Presumption of Taxability and Timing of the Tax

The tax base for the prime contracting classification is sixty-five percent of a prime contractor's gross receipts derived from the business.<sup>14</sup> Accordingly, the tax base for TPT generally includes:

the total amount of the sale, lease or rental price, as the case may be, of the retail sales of retailers, including any services that are a part of the sales, valued in money, whether received in money or otherwise, including all receipts, cash, credits and property of every kind or nature, and any amount for which credit is allowed by the seller to the purchaser without any deduction from the amount on account of the cost of the property sold, materials used, labor or service performed, interest paid, losses or any other expense.<sup>15</sup>

Any deductions, exemptions, or exclusions from TPT must be specifically provided for in statute.<sup>16</sup> Moreover, the deductions, exemptions, and exclusions from one TPT classification are unique to that classification, such that they cannot simply be read into another tax classification in which they are not explicitly provided for in statute.<sup>17</sup>

*Example:* Island Shades installs window shades that it makes in-house. Island only makes shades that it subsequently installs. Because it is a contractor rather than a manufacturer, Island cannot generally be sold machinery or equipment used in fabricating the shades exempt from retail TPT. Likewise, island cannot purchase such machinery or equipment exempt from Arizona use tax.

Fundamentally, prime contracting TPT is a tax on service activities. As such, there is no blanket exemption for labor, and no transfer of tangible personal property is needed to incur liability for the tax.

There is also no exemption for work performed for federal or state governments (or any of their agencies, instrumentalities, or political subdivisions), religious organizations, nonprofit charitable organizations, or schools. Although taxpayers may pass on the economic burden of the tax to their customers, the legal liability for the tax rests on the prime contractor.

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<sup>14</sup> A.R.S. § 42-5075(B).

<sup>15</sup> A.R.S. § 42-5001(7).

<sup>16</sup> ARIZ. CONST. art. IX, § 1 (stating "[t]he power of taxation shall never be surrendered, suspended or contracted away"); *Valencia Energy Co. v. Ariz. Dep't of Revenue*, 191 Ariz. 565, 570, 959 P.2d 1256, 1261 (1998).

<sup>17</sup> See *Brink Elec. Const. Co. v. Ariz. Dep't of Revenue*, 184 Ariz. 354, 359, 909 P.2d 421, 426 (Ct. App. 1995) (noting *Duhamé v. State Tax Commission*, 65 Ariz. 268, 179 P.2d 252 (1947) "clearly illustrates that the retail exemptions are available only to retailers as defined by the statute" and not contractors subject to prime contracting TPT).

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Therefore, taxing a prime contractor's receipts from a contract with the federal government is not the same as taxing the federal government.<sup>18</sup>

A prime contractor is not entitled to a credit under state law for tax paid by another taxpayer. A contractor may generally avoid being charged for tax on materials it will incorporate into real property by providing a retailer with an Arizona Form 5000. This exemption certificate allows the retailer to claim a deduction under A.R.S. § 42-5061(A)(27). If the contractor fails to avail itself of this process and pays the retail TPT tax amount to a retailer, it may not deduct the costs of materials from its income or take a credit against its own tax obligations in the amount that the retailer charged for retail TPT.

Similarly, a prime contractor may not deduct amounts attributable to its costs of doing business. For example, a prime contractor may not deduct amounts the contractor has paid toward rentals of machinery and equipment the contractor used on a Project or TPT paid on the rentals.<sup>19</sup>

Finally, the presumption for TPT is that

[f]or the purpose of proper administration of this article and to prevent evasion of the tax imposed by this article it is presumed that all gross proceeds of sales and gross income derived by a person from business activity classified under a taxable business classification comprise the tax base for the business until the contrary is established.<sup>20</sup>

Consequently, in determining whether TPT applies to certain receipts of a taxpayer, it is necessary to examine the totality of that taxpayer's business activities rather than review receipts on an isolated, transaction-by-transaction basis.

## The Separate-Line-of-Business Analysis

TPT is imposed on the gross receipts of a business. Moreover, "[i]f activities are incidental in the sense that they are inseparable from the principal business and interwoven in the operation thereof to the extent that they are in effect an essential part of the major business, they cannot be taxed as a separate business."<sup>21</sup> For TPT purposes, simply

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<sup>18</sup> See *United States v. New Mexico*, 455 U.S. 720 (1982); *Ariz. Dep't of Revenue v. Blaze Constr. Co.*, 526 U.S. 32 (1999).

<sup>19</sup> A lessor's gross receipts from leases and rentals of machinery and equipment that a prime contractor uses on a project are subject to TPT.

<sup>20</sup> A.R.S. § 42-5023.

<sup>21</sup> *Trico Elec. Coop., Inc. v. State Tax Comm'n*, 79 Ariz. 293, 297, 288 P.2d 782, 784 (1955). Income from services that may be concededly nontaxable if carried on by a business that is not otherwise taxable under a tax classification may nevertheless be part of a taxpayer's gross receipts derived from business activities that are the basis of the taxpayer's principal activity. See *Walden Books Co. v. Ariz. Dep't of Revenue*, 198 Ariz. 584, 587-88, 12 P.3d 809, 812-13 (Ct. App. 2000).

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separately identifying receipts is insufficient to render any receipts nontaxable, especially if the statute for the tax classification that the business reports under does not otherwise explicitly provide an exemption or deduction. Rather, the business must show that it engages in a *separate line of business* of providing a nontaxable activity (or, as applicable, an activity subject to TPT under another tax classification).

A line of Arizona case law forms the Department's separate line of business analysis. In 1947, the Arizona Supreme Court held that TPT is measured by all of the business activity of a taxpayer rather than merely a part of it.<sup>22</sup> A few years later, the court clarified that a person's activities may constitute more than one business and the taxpayer would be obligated to pay the appropriate tax on each business.<sup>23</sup>

In 1976, the Arizona Supreme Court again addressed the principle in *State Tax Commission v. Holmes & Narver, Inc.*, which dealt with the issue of whether a prime contractor's gross receipts from design and engineering services fell within the contractor's tax base.<sup>24</sup> After stating that not all business is the subject of TPT (*i.e.*, only those businesses specifically set forth in the statutes), the court held that gross receipts from a service are not part of the taxable gross receipts of the major business if three conditions are met:

1. The portion of the business that is the service in issue can be readily ascertained without substantial difficulty;
2. The revenues from the service, in relation to the taxable revenues of the business, are not inconsequential; and
3. The service cannot be said to be incidental to the other taxable activity.<sup>25</sup>

In 1995, the Arizona Court of Appeals reiterated the *Holmes & Narver* test in *City of Phoenix v. Arizona Rent-A-Car Systems*, noting that "when the amount involved is not minimal, when it can be easily calculated, and when the service it relates to is not an integral part of the main business, the main and ancillary services can be separated for tax purposes."<sup>26</sup>

Importantly, *Rent-A-Car* introduced the notion that it is the percentage of the business represented by such amounts relative to the entire business, not the absolute amounts alone, that determines what is "minimal" in nature.<sup>27</sup> The court determined that income from concededly nontaxable activity (the sale of gasoline) was part of the personal property

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<sup>22</sup> *Duhame*, 65 Ariz. at 276, 179 P.2d at 257.

<sup>23</sup> *Trico*, 79 Ariz. at 297-98, 288 P.2d at 784.

<sup>24</sup> 113 Ariz. 165, 548 P.2d 1162 (en banc).

<sup>25</sup> 113 Ariz. at 169, 548 P.2d at 1166.

<sup>26</sup> 182 Ariz. 75, 78-79, 893 P.2d 75, 78-79.

<sup>27</sup> *Id.*

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rental classification tax base for city tax purposes. In so holding, the Court of Appeals stated:

In summary, we conclude that because every Budget car rental contract includes a refueling charge, the charge is an integral part of Budget's car rental business. Because most customers return with a full gas tank, thus avoiding the refueling charge, the charge accounts for a minimal percentage of Budget's car rental business. Accordingly, refueling charges paid to Budget are taxable as gross income from the car rental business.<sup>28</sup>

If the relevant facts and circumstances fail to satisfy all three parts of the separate-line-of-business test, all gross receipts would be included in the tax base of the taxpayer's principal business. If the facts and circumstances meet the three prongs, however, the activities would exist as a separate line or lines of business. Accordingly, the taxpayer's gross receipts would be subject to tax under the appropriate tax classification for each line of business or would be nontaxable (*i.e.*, as a nontaxable service activity or activity that otherwise falls outside the scope of the TPT tax classifications). Failure to maintain appropriate books and records will result in the presumption that a taxpayer's gross receipts are subject to TPT at the highest tax rate applicable to a classification under which the taxpayer is doing business.<sup>29</sup>

Without an understanding of the separate-line-of-business principle, one might erroneously assume that an activity that, when viewed in isolation, might be considered nontaxable, could be rendered so simply by separately stating receipts from that activity on invoices or in books and records.

This concept of a separate line of business is especially relevant, in the prime contracting context, for a contracting business that claims deductions for certain activities that are related to its primary taxable contracting activity.

One exception to the separate-line-of-business applies in the case of a business that derives most of its gross receipts from its retail business activities but that derives some receipts from performing or coordinating taxable modifications. In such an instance, there is a retail TPT exclusion found at A.R.S. § 42-5061(A)(6) for "[b]usiness activity which is properly included in any other business classification which is taxable under [A.R.S. Tit. 42, Ch. 5, Art. 2]." This exclusion permits the retail business to pay prime contracting TPT on those receipts derived from modification activities, assuming that the receipts are separately stated in the business's books and records. If the business fails to maintain

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<sup>28</sup> 182 Ariz. at 80, 893 P.2d at 80.

<sup>29</sup> See A.A.C. R15-5-2004(C).

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proper books and records, all of its gross receipts will be subject to the higher, retail TPT rate.

## *Examples:*

1. Imperial Heating and Cooling, an HVAC contractor, offers annual inspection services wherein it may assess, clean, and restore HVAC systems as needed. Although inspection services, when viewed in isolation, might be considered nontaxable, because the nature of the annual inspections is interwoven with its principal business as a whole, Imperial's gross receipts from the inspections will fall within the tax base for prime contracting TPT.
2. Peninsula Elevator Co. exclusively distributes and installs PILAR brand elevators. Additionally, it offers warranty contracts, under which it provides repair and maintenance services within the contract period on customers' PILAR elevators, regardless of whether Peninsula originally installed them. Finally, Peninsula also offers cleaning and janitorial contracts, under which it provides elevator cleaning services during the contract period. Peninsula's gross receipts from all activities will generally be subject to prime contracting TPT. Although cleaning and janitorial services, when viewed in isolation, might be considered nontaxable, they will not be treated differently from other taxable receipts unless Peninsula can establish that it engages in a separate, nontaxable service line of business.
3. Greenwood Contracting, a prime contracting business, has purchased lumber and other building materials for a Project that has just been completed and wishes to sell the excess goods. The gross receipts that Greenwood derives from the sale of such materials would generally be considered subject to TPT under the prime contracting classification (*i.e.*, on sixty-five percent of the contractor's gross receipts). If Greenwood is engaged in a separate retail line of business, the gross receipts from the sale of the materials would be subject to retail TPT under A.R.S. § 42-5061.
4. Greenwood Contracting also owns several pieces of heavy construction equipment, from which it derives gross receipts by renting them to other contractors when they would otherwise sit idle. In such a case, Greenwood's gross receipts from the equipment would be generally be subject to TPT under the prime contracting classification. Again, if Greenwood is engaged in a separate rental line of business, the gross receipts from the equipment rentals

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would be subject to TPT under the personal property rental classification found at A.R.S. 42-5071.

5. Broadmead Audio & Visual is a retailer of home theater systems that also installs some of the equipment that it sells at retail. As a business that is primarily engaged in retail sales, Broadmead can separately report its receipts for its installation work under the prime contracting classification and remit prime contracting TPT for them without showing that it is engaged in a separate line of business. Broadmead must maintain its books and records to show that its gross receipts from the retail sales of the equipment fall within its retail TPT tax base and its gross receipts from equipment installations fall within its prime contracting TPT tax base. If Broadmead fails to properly maintain its books and records, all of its gross receipts will be subject to retail TPT, which has the highest tax rate of the classifications under which it does business.

## Exemptions for the Cost of Materials and Receipts from Contracting Activities Relating to Exempt Tangible Personal Property

The prime contracting classification includes two deductions that relate to machinery, equipment and other tangible personal property that is exempt under the retail classification and use tax. The first, A.R.S. § 42-5075(B)(9), exempts

[t]he gross proceeds of sales or gross income attributable to the purchase of machinery, equipment or other tangible personal property that is exempt from or deductible from transaction privilege and use tax under:

- (a) Section 42-5061, subsection A, paragraph 25 or 29.
- (b) Section 42-5061, subsection B.
- (c) Section 42-5159, subsection A, paragraph 13, subdivision (a), (b), (c), (d), (e), (f), (i), (j) or (l).
- (d) Section 42-5159, subsection B.

This deduction applies only to the purchase price for the property that is exempt under the relevant A.R.S. § 42-5061 deductions or A.R.S. § 42-5159 exemptions. The purchase price is the price that the prime contractor paid to acquire the tangible personal property at issue, not the amount that the contractor subsequently receives from its customers for the same property. A.R.S. § 42-5075(B)(9) does not allow the prime contractor to deduct any markup on the exempt property or any receipts the contractor derives from modifications to the real property.

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Under A.R.S. § 42-5061(B)(7), if a prime contractor installs, assembles, repairs, or maintains machinery, equipment, or some other tangible personal property that is exempt under an A.R.S. § 42-5061(B) retail deduction or A.R.S. § 42-5159 use tax exemption and that does not become a permanent attachment to the real property, the gross receipts from such activities are deductible.<sup>31</sup> In analyzing this exemption under A.R.S. § 42-5075(B)(7), the first question is whether the machinery, equipment or other tangible person property is exempt under A.R.S. § 42-5061(B) or § 42-5159(B). The second question is whether the property is permanently attached. The third question is whether the prime contractor's receipts are directly attributable to the installation, assembly, repair or maintenance of the exempt, permanently attached property. The receipts are only exempt from the prime contracting TPT base if the answer is yes to all three questions.

A.R.S. § 42-5075(B)(7) provides that "permanent attachment" to realty means one or more of the following three conditions:

- a. To be incorporated into real property.
- b. To become so affixed to real property that it becomes a part of the real property.
- c. To become so attached to real property that removal would cause substantial damage to the real property from which it is removed.

Considering the three prongs of the A.R.S. § 42-5075(B)(7) permanent attachment definition individually:

- To become incorporated into real property, tangible personal property would have to be physically combined with or imbedded in the real property so as to be made part of the real property. Examples of personal property incorporated into real property include equipment bolted into a concrete base, pipes and wiring installed in the walls of the property or related structures, and pipes buried underground.
- Affixation to real property refers to the law of fixtures. The longstanding common law of fixtures employs a test to determine whether tangible personal property constitutes real property or retains its identity as personalty. For chattel to become a fixture and be considered real property if all three of the following conditions are met:
  1. There must be an annexation to the realty or something appurtenant thereto.
  2. The chattel must have adaptability or application as affixed to the use for which the real estate is appropriated.

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<sup>31</sup> It is important to understand that a prime contractor retains its identity as a taxpayer, for purposes of A.R.S. § 42-5075, even if some of its receipts are deductible by virtue of A.R.S. § 42-5075(B)(7). In other words, the deduction does not imply that any of its other gross receipts that are *not* directly derived from installing, assembling, repairing, or maintaining exempt tangible personal property are exempt under A.R.S. § 42-5075.

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3. There must be an intention of the party to make the chattel a permanent accession to the freehold. Under normal circumstances, the Department will look at objective indicia of intent when making this determination.<sup>32</sup>

The Court of Appeals' decision in *Arizona Department of Revenue v. Arizona Outdoor Advertisers, Inc.*<sup>33</sup> adds an additional dimension to this three-part fixtures test with the "reasonable person" test, which the court held applies "in the context of characterizing property as real or personal for tax purposes. The focus of a reasonable person inquiry is, "Would a reasonable person, after considering all the relevant circumstances, assume that the item in question belongs to and is a part of the real estate on which it is located?"<sup>34</sup> To wit, the court stated:

The . . . test . . . maintains the preferred standard of objective measurement and corrects for the major shortcomings of the [three-part] *Teaff* [fixtures] test [from *Teaff v. Hewitt*, 1 Ohio St. 511 (1853)], namely artificial restriction of the test to the time of original annexation, unjustifiable confinement of the process to just the three *Teaff* factors, and unwarranted exclusion of evidence of subjective intent, either of the original annexor or of the parties to an agreement regarding the property. . . . While *Teaff's* three factors will no longer limit the inquiry, they will continue to play a major role. In fact, annexation will probably continue as the triggering event for most fixtures inquiries.<sup>35</sup>

While *Arizona Outdoor's* reasonable person test should be considered in an analysis of A.R.S. § 42-5075(B)(7)(b),<sup>36</sup> it is also important to note that the Court of Appeals was clarifying the broader scope of "improvements" vis-à-vis "fixtures," in that an improvement encompasses everything that permanently enhances the value of real property for general use, while fixtures constitute a subset of the broader category of "improvements."<sup>37</sup>

- The substantial damage part of the test is self-explanatory. It includes any scenario wherein removal causes damage such that subsequent corrective or remediation action would have to be taken to return the property to a substantially similar condition as existed before removal, regardless of whether such corrective or remediation action is actually taken.

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<sup>32</sup> See, e.g., *Fish v. Valley Nat'l Bank*, 64 Ariz. 164, 170, 167 P.2d 107, 111 (1946); see also *Murray v. Zerbel*, 159 Ariz. 99, 101, 764 P.2d 1185, 1160 (Ct. App. 1988).

<sup>33</sup> 202 Ariz. 93, 41 P.3d 631 (2002).

<sup>34</sup> 202 Ariz. at 99-100, 41 P.3d at 637-38.

<sup>35</sup> 202 Ariz. at 100, 41 P.3d at 638.

<sup>36</sup> The reasonable person test does not apply to the "incorporation" prong of A.R.S. § 42-5075(B)(7)(a) or "substantial damage" prong of A.R.S. § 42-5075(B)(7)(c).

<sup>37</sup> 202 Ariz. at 96, 41 P.3d at 634.

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It is important to note that the A.R.S. § 42-5075(B)(7) deduction does not include modifications to the real property or Project made to prepare for or facilitate installation, assembly, repair, or maintenance of the tangible personal property. The gross receipts derived from such activities would generally be subject to prime contracting TPT.

## **Who is a Taxable "Prime Contractor"**

### Prime Contractors, Generally

A "prime contractor" is

a contractor who supervises, performs or coordinates the modification of any building, highway, road, railroad, excavation, manufactured building or other structure, project, development or improvement including the contracting, if any, with any subcontractors or specialty contractors and who is responsible for the completion of the contract.<sup>38</sup>

A contractor is anyone who undertakes to, or offers to undertake to, or purports to have the capacity to undertake to, or submits a bid to, or does personally or through others, modify a Project.<sup>39</sup> A contractor does not have to actually have the ability to perform the modification activities itself.

The term of prime contractor is not synonymous with "general contractor." The prime contractor need only be responsible for the completion of its contract that requires it to supervise, perform, or coordinate the modification. A prime contractor does not have to be responsible for the completion of the entire Project.

*Example:* Norm, an electrician, enters into a contract with a general contractor to provide electrical work in a new construction home. Norm will be presumed to be a prime contractor and taxable on his gross receipts, even if he has no responsibility for any other aspect of the house construction.

### Subcontracting and TPT Liability

Although all contractors are generally presumed to be taxable prime contractors, some receipts of a contractor may be deductible from prime contracting TPT when they arise from qualifying subcontracting activities. A contractor bears the burden of proof to show that gross receipts from a particular Job are derived from such qualifying subcontracting activities. To do this, it must show:

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<sup>38</sup> A.R.S. § 42-5075(O)(8).

<sup>39</sup> A.R.S. § 42-5075(O)(2).

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1. The contractor performed a Job on a Project that was under the control of one or more prime contractors;
2. The prime contractor is liable for tax on the gross receipts attributable to the Project; and
3. The contractor receives its payments out of the prime contractor's taxable gross receipts derived from the Project.<sup>40</sup>

Alternately, a contractor can deduct its receipts from qualifying subcontracting activities by obtaining an Arizona Form 5005 from the prime contractor responsible for the tax when it enters a contract.<sup>41</sup> An Arizona Form 5005 certifies that the person executing the certificate is assuming liability for the prime contracting TPT applicable to the Projects listed on the certificate.

Contractors who timely receive a fully completed Arizona Form 5005 in good faith will not be required to pay TPT on their gross receipts from a Job, regardless of whether they would otherwise be considered prime contractors under A.R.S. § 42-5075.<sup>42</sup> Parties assuming liability as prime contractors by executing an Arizona Form 5005, however, are liable for and must remit TPT at the time that the parties for whom they assume TPT liability would otherwise have been liable for the tax. The use of a certificate other than the Arizona Form 5005 (e.g., the Multistate Tax Commission's Uniform Sales and Use Tax Certificate—Multijurisdiction) is *not* effective to make such a designation; similarly, certificates that have been altered by parties receiving the certificates are invalid.

For a contractor's receipts to be considered derived from qualifying subcontracting activities, the contractor must work for a party that is subject to TPT on receipts from the work under the prime contracting classification rather than another tax classification (e.g., telecommunications, utilities).

*Example:* Ryan, an independent cable installer, is hired by a cable system operator to install distribution line wiring from a street into a cable subscriber's residence. The cable system operator does not engage in any modifications itself. In this instance, Ryan does not engage in any qualifying subcontracting activities, because the party for whom he works is not a prime contractor for his Job. Ryan is the prime contractor and is subject to prime contracting TPT on his receipts from the Job. Any fees derived from installation by the cable system operator will generally be subject to telecommunications TPT, unless otherwise deductible or exempt by statute.

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<sup>40</sup> See A.R.S. § 42-5075(D).

<sup>41</sup> A.R.S. § 42-5075(E).

<sup>42</sup> In this context, good faith means that a contractor has no reason to believe that the content provided in the Arizona Form 5005 is incorrect.

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## Real Property Owners as Prime Contractors

Before September 19, 2007, real property owners who did not perform their own modifications may have been liable for tax if it entered a contract for sale before substantial completion of modifications to the real property. The liability would have been imposed on the gross receipts derived by the owner-developer, excluding the fair market value of the land. Assuming a contractor or contractors working for the owner-developer had been deemed prime contractors before this point, TPT liability would "shift" from such persons to the owner-developer at the point the contract for sale was entered. A.R.S. § 42-5075 provides no credit or deduction for amounts that may already have been paid by subcontractors of an owner-developer before the owner-developer entered the contract for sale, so no adjustments would be made to the owner-developer's liability under these circumstances.

Laws 2007, Ch. 188, derived from the Senate-engrossed version of House Bill ("H.B.") 2627, introduced the A.R.S. § 42-5075(O)(8) exclusion from the prime contractor definition provided above, for "a person who owns real property, who engages one or more contractors to modify that real property and who does not itself modify that real property . . . [,] regardless of the existence of a contract for sale or the subsequent sale of that real property."

Nevertheless, the A.R.S. § 42-5075(O)(8) exclusion does not apply in two situations in which such owners of real property can still be liable for TPT. Such owners would be liable for TPT:

1. If, pursuant to A.R.S. § 42-5075(E), a real property owner provides contractors modifying the Project with an Arizona Form 5005 assuming liability for payment of TPT on the Project. In such a case, the owner is liable for TPT in the amounts that would otherwise be remitted by its subcontractors.
2. If, pursuant to A.R.S. § 42-5075(N), a real property owner enters a contract for sale of the real property, is responsible to the purchaser for modifications to the property in the period subsequent to the transfer of title (e.g., tenant improvements), and receives a consideration for the modifications. The actual contracting activities need not be directly performed by the seller for liability to attach. The seller's TPT liability would be for the purpose of taxing the gross proceeds of sales or gross income the seller receives for the modifications made subsequent to the transfer of title.

A.R.S. § 42-5075(O)(8) does not affect those real property owners who perform some or all of the modifications themselves on Projects on behalf of third parties. Such owners would generally be considered prime contractors and subject to tax on their gross receipts. For example, in a "construction arm-marketing arm" arrangement, the construction arm entity would still be considered a prime contractor.

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The A.R.S. § 42-5076 owner builder sales classification imposes TPT on a person who sells real property within 24 months after improving the real property. This statute, however, applies only to *existing* buildings, highways, roads, or other structures or projects that were suitable for occupancy prior to the improvements. Moreover, the statute does not apply to improvements to raw land. Consequently, the application of TPT for property owners who purchase materials and perform modifications on their own property results in: (a) retailers paying retail TPT on the materials purchased by the owner builder and (b) any contractors engaged by the owner builder paying prime contracting TPT on their gross receipts.

## **Examples of Prime Contracting Activities**

### Handymen

Handymen—persons hired to perform various small tasks or odd jobs around residential or commercial properties—are often not required to be licensed by ROC. Nevertheless, such an exemption from ROC licensure does not mean that those persons are not liable for TPT as prime contractors. The same analysis that has been provided for contractors thus far must be performed to determine whether a handyman's gross receipts are subject to TPT under A.R.S. § 42-5075.

### Labor-only Contracting

As mentioned above, prime contracting TPT is a tax on service activities. Consequently, taxable modifications do not require the prime contractor to furnish any tangible personal property.

*Example:* Lenka hires Grayson to install a ceiling fan and retouch the paint on some surfaces in her home. Lenka purchases the paint that Grayson uses and the fan he installs. Grayson is liable for TPT on his gross receipts, regardless of the fact that another party has purchased the materials that he uses to perform the taxable modifications.

### Earthmoving and Related Activities as Taxable Activities

Gross receipts derived from various activities that affect land (e.g., improvements, movements) are generally subject to prime contracting TPT, unless otherwise exempted by statute. The pre-September 2011 rules covered specific examples of such activities, such as agricultural activity, leveling, ditching, well drilling, installing well pumps, and land

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clearing; the reason is because they constitute improvements to the land by statute.<sup>43</sup> In 2002, however, the Legislature enacted specific statutory provisions addressing landscaping and land maintenance activities, which superseded the rules.<sup>44</sup>

Not all such activities would be performed in furtherance of a making or modifying an improvement to real property. For example, one exception noted in the expired rules is for exploratory drilling activities (e.g., core drilling for testing purposes), based on the reasoning that such drilling is not performed in furtherance of making improvements to the land and, consequently, not a contracting activity encompassed within the prime contracting TPT tax base.

It is important to reiterate, however, that determining whether TPT applies to the receipts of a prime contractor performing both taxable and nontaxable improvements will necessitate examining the totality of the contractor's activities rather than reviewing receipts on a transaction-by-transaction basis.

### Construction Management

Construction managers, or contractors that use their experience and knowledge to manage construction sites for property owners, are generally prime contractors and therefore liable for TPT on fees for their services. Construction managers that enter into contracts directly with trade contractors are subject to tax on the amounts paid to the trade contractors, regardless of whether the payments come from the property owners. If construction managers do not enter into contracts directly with the trade contractors (e.g., the trade contractors contract with the property owner), they are not subject to tax on the amounts paid to the trade contractors; rather, the individual trade contractors are the prime contractors and subject to TPT on their receipts.

### Offsite Improvements

Property owners constructing new developments will generally build improvements such as access roads, sidewalks, gutters, and curbs. Rather than being sold as part of the developments' lots, these improvements are usually deeded to a city, town, or homeowner association. Even if the property owners act as prime contractors in constructing the buildings on the lots, they are generally not considered prime contractors with respect to the offsite improvements, because the improvements are costs of doing business and the property owners do not derive gross receipts from these improvements. Therefore, the trade contractors that construct the offsite improvements will be considered the prime contractors for them.

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<sup>43</sup> See A.R.S. § 42-5075(O)(5), 42-5075(O)(8) ("construction, alteration, repair, addition, subtraction, improvement, movement, wreckage[,] or demolition" to an "excavation . . . or other . . . project, development[,] or improvement").

<sup>44</sup> See Laws 2002, Ch. 307, § 1 (originally H.B. 2242).

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## City Tax

Major differences exist between the state's taxation of prime contracting under the Arizona Revised Statutes, and the cities' three categories of taxation of "construction contracting" under the Model City Tax Code ("MCTC").

The imposition of city privilege taxes is separate and distinct from the imposition of the state's TPT and accompanying county excise taxes. The League of Arizona Cities and Towns (the "League") created the MCTC for the purposes of the imposition and administration of city privilege taxes. All Arizona cities utilize the MCTC in the imposition of their privilege taxes and use taxes, based upon their local ordinances. Certain options exist, allowing each city to alter or qualify the imposition of its privilege tax or use tax.

In addressing the taxation of building activities, the MCTC provides three business categories. Two of the cities' three categories address building activities involving non-"prime contractors." The MCTC taxes "speculative builders" under Section 416, and taxes "owner-builders who are not speculative builders" under Section 417. The third MCTC section applies to "construction contractors," whose activities are generally equivalent to the state's "prime contractors."

The larger Arizona cities administer their own tax programs. These cities are referred to as "non-program" cities. The smaller Arizona cities' tax programs are administered by the Arizona Department of Revenue. These cities are referred to as "program" cities. Telephone numbers for the non-program cities are available from the League's Model City Tax Code website at <http://www.modelcitytaxcode.org>. The Department's Cities Program Liaison can be contacted with questions regarding program cities' privilege taxes.