



ARIZONA TRANSACTION PRIVILEGE TAX PROCEDURE TPP 14-X

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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 business that is principally engaged in manufacturing or smelting operations and that uses at least fifty-one per cent of the electricity or natural gas in the manufacturing or smelting operations.

A.R.S. 42-5063(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 processing, fabricating, job printing, 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.

BACKGROUND:

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 vendor, not the purchaser. The vendor may pass the burden of the tax on to the purchaser; however the vendor is the

ARIZONA TRANSACTION PRIVILEGE TAX PROCEDURE

TPP 14-X

Page 2

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.

Each year, the Legislature enacts new tax provisions into law. During the first regular session of the 2014 legislative session, the legislature enacted a deduction under A.R.S. § 42-5063(C)(6), for, “gross proceeds of sales or gross income derived from sales of electricity or natural gas to a business that is principally engaged in manufacturing or smelting operations and that uses at least fifty-one per cent of the electricity or natural gas in the manufacturing or smelting operations.” The Legislature defined “manufacturing” by taking the definition used in Arizona Administrative Code (A.A.C.) R15-5-120(A) and incorporating it into the statute.

PROCEDURE:

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. Assembling different parts is not considered manufacturing. For example, a company that takes used computer parts and puts them into a used computer shell is assembling and therefore not manufacturing.

The statutory definition also specifically excludes other activities from manufacturing: processing, fabricating, job printing, 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 or prepared food sale location. Processing includes a company that makes, packages, and sells ice; a company that

ARIZONA TRANSACTION PRIVILEGE TAX PROCEDURE

TPP 14-X

Page 3

pasteurizes milk; and a local pizza chain that has a site that only makes pizza dough and puts together salads for distribution to all their retail stores. Fabrication includes a company that attaches a layer of silicon to silicon wafers and a company that makes sheet metal components.

Procedure to Determine Whether a Business is Principally Engaged in Manufacturing or Smelting

After a purchaser has determined it has manufacturing or smelting activities then it must determine if it is principally engaged in manufacturing or smelting operations. "Principally engaged" means at least fifty-one per cent of the business is a manufacturing or smelting operation. "Business" means either the business entity or the facility at which the manufacturing or smelting takes place. The business entity qualifies if at least 51% of the business is principally engaged in manufacturing or smelting operations. If the business does not qualify at the entity level it may still qualify for the deduction at the facility level. A business is principally engaged in manufacturing or smelting operations if it can demonstrate fifty-one per cent of the business is directly related to manufacturing or smelting through 2 (two) of the following criteria: capital equipment costs, revenue, head count, and/or square footage. Support staff or facilities are not directly related to manufacturing or smelting. If the purchaser's business cannot ascertain one or more of the listed criteria it can still qualify as a manufacturing or smelting operation as long as two criteria meet the threshold.

Revenue

In order to qualify for this criteria for 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, for example, the product must be sent to another facility for further processing, the purchaser cannot use this criteria, but may qualify using other criteria. For the purposes of determining revenue, a one-year period is required. Facilities or businesses in operation less than one year may project their anticipated revenue.

Capital equipment costs

In order to qualify under this criteria for the deduction, at least 51% of the capital equipment costs must be derived from its manufacturing or smelting operation in Arizona. For the purposes of determining capital equipment costs, the capital cost in Arizona on December 31st of the prior year shall be utilized to determine the percentage used in manufacturing or smelting.

Head count

Head count refers to the number employees of your business. The percentage of employees in Arizona directly related to manufacturing or smelting must be at least 51% to

ARIZONA TRANSACTION PRIVILEGE TAX PROCEDURE

TPP 14-X

Page 4

qualify for this criteria for 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.

Square footage

The percentage of square footage in Arizona directly related to manufacturing or smelting must be at least 51% to qualify for this criteria for the deduction. For the purposes of determining square footage, the square footage of Arizona facilities on December 31st of the prior year shall be utilized to determine the percentage used in manufacturing or smelting.

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 2 (two) of the criteria. 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.

1.	Revenues received from manufacturing/smelting in Arizona	\$
2.	Gross revenues from business in Arizona	\$
3.	Divide line 1 by line 2. This is your percentage of revenue from manufacturing/smelting in Arizona.	%
4.	Number of employees engaged in manufacturing/smelting in Arizona.	
5.	Total number of employees in Arizona.	
6.	Divide line 4 by line 5. This is your percentage of employees engaged in manufacturing/smelting in Arizona.	%
7.	Facility's capital/equipment costs attributable to cost of manufacturing/smelting in Arizona.	\$
8.	Facility's overall capital/equipment costs in Arizona.	\$
9.	Divide line 7 by line 8. This is your percentage of facility's capital/equipment costs related to manufacturing/smelting in Arizona.	%
10.	Square footage of floor space of business in Arizona dedicated to manufacturing/smelting	
11.	Total square footage of business in Arizona	
12.	Divide line 10 by line 11. This is your percentage of facility's floor space dedicated to manufacturing/smelting	%

ARIZONA TRANSACTION PRIVILEGE TAX PROCEDURE

TPP 14-X

Page 5

Procedure to Determine Electricity or Natural Gas Used in Manufacturing or Smelting

Once a purchaser has determined it is a business that is principally engaged in manufacturing or smelting operations, it must then also determine that it uses at least fifty-one percent of the electricity or natural gas in the manufacturing or smelting operations. A business or facility at which 51% or more of the electricity or natural gas used by the facility is consumed in manufacturing or smelting will qualify for the deduction. To qualify, the electricity or natural gas must be consumed in manufacturing or smelting performed by the purchaser, not by or through another person. The percentage is determined by the percentage of electricity or natural gas used by the facility's manufacturing or smelting operation in the prior calendar year.

Complete the *Worksheet for Figuring the percentage of electricity or natural gas consumed in manufacturing or smelting* to determine if at least fifty-one percent of electricity or natural gas is consumed in manufacturing or smelting. 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 electricity or natural gas is consumed in manufacturing or smelting.

Worksheet for figuring the percentage of electricity or natural gas consumed in manufacturing or smelting

1.	Total quantity of electricity (kWh) or natural gas (BTU) used in facility's manufacturing or smelting operation.	
2.	Total quantity of electricity (kWh) or natural gas (BTU) used by facility	
3.	Divide line 1 by line 2. This is your percentage of electricity or natural gas used by facility in the manufacturing or smelting operation	%

The use of separate meters measuring the amount of electricity or natural gas usage for manufacturing or smelting performed at a facility is acceptable for establishing qualification for a deduction for the facility. Nevertheless, the facility's qualification for the exemption is limited to the electricity or natural gas used at the qualifying facility. The cost of gas transportation services is not eligible for the deduction. If the billing is bundled with other fees and costs not associated with manufacturing or smelting, then the entire billing does not qualify for the deduction.

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

If both prongs of the test are proven, the manufacturer or smelter would then provide a certificate to the vendor, citing the basis for the deduction. The department has issued a

ARIZONA TRANSACTION PRIVILEGE TAX PROCEDURE

TPP 14-X

Page 6

general exemption certificate, Arizona Form 5000, to be used in documenting that a transaction is not subject to transaction privilege tax.

- 1) The sales invoice must be marked to indicate that the amount of the sale was deducted from the tax base; and,
- 2) A certificate must be on file from the purchaser that indicates:
 - Name and address of the purchaser;
 - If the deduction is for the business as a whole, the address should be the main address for the business
 - If the deduction is for a facility only, the address should be the facility address
 - Precise nature of the purchaser's business;
 - Purpose for which the purchase was made;
 - The necessary facts to establish the appropriate deduction (description of property purchased and its use);
 - The tax license number (if the deduction depends on the purchaser conducting business under a specific tax classification).

The certificate must be signed by a person authorized to sign on behalf of or as representative for the purchaser. A certificate shall be required for each facility at which the purchaser has a manufacturing or smelting operation. Additionally, the utility account numbers that qualify for the deduction must be indicated on the form or an attached addendum.

Pursuant to A.R.S. § 42-5009(C), the Department of Revenue has adopted certificates based on the requirements of Subsection A of this section. 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 under the transaction privilege tax if the vendor had not complied with A.R.S. § 42-5009(A). Payment of this amount exempts the purchaser from liability for any use tax.

The department may require the **vendor** to establish the accuracy of the information provided on a departmental certificate 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

ARIZONA TRANSACTION PRIVILEGE TAX PROCEDURE

TPP 14-X

Page 7

freedom from knowledge of circumstances that should cause the vendor to deny the claimed deduction or exemption.

For purposes of a deduction or exemption claimed under Arizona Revised Statutes and the associated use of a certificate issued by the department, the term "blanket" (sometimes referred to as "annual") refers to the time period for which a certificate is valid. A blanket certificate may be accepted by the vendor if the purchaser and vendor agree to its use and to the time period for which it will be valid. However, the vendor must have a certificate on file for each statutorily authorized deduction or exemption for the time period so designated. This does not mean that every item purchased must have a separate certificate. All items qualifying under the same deduction or exemption (i.e., a sale for resale) may be purchased tax exempt under the same valid certificate. When an item is sold under another type of deduction or exemption, the vendor must obtain a separate valid certificate.

If during the agreed upon time period the vendor believes that the certificate is no longer valid, the vendor should refuse to honor the sale as exempt. If during the time period established by the blanket certificate the purchaser attempts to claim tax exemption on the purchase of an item which is outside the statutory deduction or exemption claimed on a blanket certificate, the vendor must require another certificate to establish the different statutory exemption or recognize that the sale is subject to tax.

David Raber, Director

Date

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.