ARIZONA TRANSACTION PRIVILEGE TAX RULING

TPR 00-2

This substantive policy statement is advisory only. A substantive policy statement does not include internal procedural documents that only affect the internal procedures of the agency and does not impose additional requirements or penalties on regulated parties or include confidential information or rules made in accordance with the Arizona administrative procedure act. If you believe that this substantive policy statement does impose additional requirements or penalties on regulated parties you may petition the agency under Arizona Revised Statutes § 41-1033 for a review of the statement.

ISSUE:

The transaction privilege tax implications of prime contracting activities that include the installation of machinery, equipment and other tangible personal property qualifying for deduction from tax under A.R.S. § 42-5061(B), under Laws 1996, Chapter 319 (S.B. 1280), and under Laws 1998, Chapter 90 (S.B. 1323), effective January 1, 1999. This ruling is applicable for tax periods beginning January 1, 1999.

APPLICABLE LAW:

Arizona Revised Statutes (A.R.S.) § 42-5061 provides exemption and deductions from the tax base under the retail classification for the gross proceeds of sales or gross income derived from retail sales of certain tangible personal property.

A.R.S. § 42-5075 levies the transaction privilege tax on the business of prime contracting. Prime contracting includes altering, repairing, improving, adding to or subtracting from any building, structure, improvement, or other project. The tax base for the prime contracting classification is 65 percent of the gross proceeds of sales or gross income derived from the business.

A.R.S. § 42-5075(B)(7) provides a deduction for the gross proceeds of sales or gross income derived from a contract to install, assemble, repair or maintain machinery, equipment or other tangible personal property that is deducted from the tax base under the retail classification and is not permanently attached to real property. This deduction does not include gross proceeds of sales or gross income from that portion of any contracting activity which consists of the development of, or modification to, real property in order to facilitate the installation, assembly, repair, maintenance or removal of machinery, equipment or other tangible personal property that is deducted from the tax base of the retail classification pursuant to A.R.S. §§ 42-5061(B) and 42-5159(B). This deduction is effective from July 1, 1997.

A.R.S. § 42-5075(b)(9) provides a deduction for the 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) or (j).

d) Section 42-5159, subsection B.

This deduction is effective January 1, 1999.

DISCUSSION:

The transaction privilege tax is divided into 17 different business classifications. The tax base for most classifications is the gross proceeds of sales or gross income derived from the business. Each classification has specific deductions and exclusions from the tax base. These specific deductions and exclusions are only applicable to businesses operating under the applicable classification.

A. PRIME CONTRACTING.

Transaction privilege tax is separately imposed on the business of selling tangible personal property at retail and the business of prime contracting. The retail classification provides deductions for certain items sold by a retail business. Deductions or exclusions under the retail classification are not available to businesses operating under the prime contracting classification.

1. The Deduction Under A.R.S. § 42-5075(B)(7).

The Arizona Court of Appeals held that a prime contractor that installs electrical equipment at electric substations does not sell tax-exempt equipment at retail but performs taxable construction work. The electrical equipment does not have to be permanently attached to the real property in order for the work to qualify as construction work. The prime contractor only has to improve real property. *Brink Electric Construction Company, Ball, Ball & Brosamer v. ADOR*, 184 Ariz. 354, 909 P.2d 421 (App. 1995).

The Legislature enacted Laws 1996, Chapter 319, effective July 1, 1997, to provide a deduction under the prime contracting classification for the gross proceeds derived from the installation of machinery and equipment or other tangible personal property that would be exempt from tax under subsection B of the retail classification when the installation of the property does not meet the permanent attachment test.

The gross proceeds of sales or gross income derived from a contract to install, assemble, repair or maintain machinery, equipment or other tangible personal property that is deducted from the tax base under subsection B of the retail classification that does not become permanently attached to the project may be deducted from the tax base. For purposes of the deduction under A.R.S. § 42-5075(B)(7) the term "permanently attached" means at least one of the following:

(a) the tangible personal property is incorporated into real property;

(b) the tangible personal property is so affixed to real property that it becomes a part of the real property; or

(c) the tangible personal property is so attached to real property that removal would cause substantial damage to the real property from which it is removed.

The existence of any one of the three factors means that the tangible personal property is permanently attached and the income derived from the installation contract is subject to tax under the prime contracting classification.

The deduction is only for the gross proceeds of sales or gross income derived from the installation, assembly, repair or maintenance of the qualifying machinery, equipment or other tangible personal property. A deduction is not provided for the prime contractor’s proceeds attributable to providing the machinery, equipment or tangible personal property. In addition, the deduction does not include that portion of any contracting activity which consists of the development of, or modification to, real property in order to facilitate the installation, assembly, repair, maintenance or removal of machinery, equipment or other tangible personal property.

Through December 31, 1998, a prime contractor’s proceeds attributable to providing machinery, equipment or other tangible personal property that was installed, assembled, repaired or maintained was not deductible unless the owner and the contractor had entered into a written agency agreement. (See TPR 00-1 for further details.) With the enactment of A.R.S. § 42-5075(B)(9) the need for agency agreements in these instances was eliminated after January 1, 1999.

2. The Deduction Under A.R.S. § 42-5075(B)(9).

The Legislature enacted Laws 1998, Chapter 90, effective January 1, 1999, to provide a deduction under the prime contracting classification for the gross proceeds attributable to the purchase of machinery and equipment or other tangible personal property that would be exempt from tax under subsection A, paragraph 25 or 29, subsection B of the retail classification and the parallel use tax provisions.

A.R.S. § 42-5075(B)(9) provides a deduction under the prime contracting classification for the 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) or (j).

d) Section 42-5159, subsection B.

The deduction is only applicable for the amount of the gross proceeds of sales or gross income attributable to the cost of qualified machinery, equipment or other tangible personal property purchased by the contractor. A deduction from the tax base is *not* provided for the gross proceeds of sales or gross income derived from the prime contracting activity to install, assemble, repair, maintain or remove the machinery or equipment.

The deduction is effective January 1, 1999. Consequently, prime contractors are no longer required to enter into agency agreements when purchasing machinery, equipment or other tangible personal property that is exempt from or deductible from transaction privilege and use tax under the referenced sections in order to deduct the cost of providing qualifying machinery, equipment and other tangible personal property under the prime contracting classification.

3. Qualifying Machinery, Equipment or Other Tangible Personal Property.

Refer to A.R.S. § 42-5061(B) for a listing of tangible personal property qualifying for the deduction under A.R.S. § 42-5075(B)(9). Refer to A.R.S. § 42-5159(B) for the *use tax* deductions.

Refer to A.R.S. § 42-5061(A)(25) and (29) for a listing of qualifying organizations for which tangible personal property may be purchased exempt from tax.

B. Agency Agreements.

As previously stated under A.R.S. § 42-5075(B)(9) prime contractors are not required to enter into agency agreements when purchasing qualified machinery, equipment or other tangible personal property that would be exempt from tax under subsection A, paragraph 25 or 29, subsection B of the retail classification and the parallel use tax provisions.

Effective January 1, 1999, the proceeds a prime contractor receives from a project owner as reimbursement for *the purchase of qualified machinery, equipment or other tangible personal property* is excludable from the prime contractor's gross contracting revenue before computing the tax base for the project.

C. DOCUMENTATION TO SUBSTANTIATE DEDUCTIONS.

See Arizona Transaction Privilege Tax Procedure TPP 00-3, *Procedure for Use of Exemption Certificates*.

RULING:

The deduction under A.R.S. § 42-5075(B)(9) is for the gross proceeds of sales or gross income attributable to the contractor’s *purchase price* of machinery, equipment or other tangible personal property that is exempt from or deductible from transaction privilege and use tax according to the statute.

Effective January 1, 1999, with or without an agency agreement, the amount a prime contractor receives from a project owner as reimbursement for the purchase of *qualified* machinery, equipment or other tangible personal property is excludable from the prime contractor's gross contracting revenue before computing the tax base for the project under A.R. S. § 42-5075(B)(7) and (9).

Under A.R.S § 42-5061(B)(7) a prime contractor can deduct the gross proceeds of sales or gross income of a contract to install, assemble, repair or maintain qualified machinery and equipment and other tangible personal property that does not become a permanent attachment to real property when computing its tax base. However, the portion of any contracting activity that consists of the development of, or modification to, real property in order to facilitate the installation, assembly, repair, maintenance or removal of the machinery, equipment or other tangible personal property may not be deducted.

Under A.R.S. § 42-5075(B)(9) the gross proceeds of sales or gross income derived from a contract to permanently install, assemble, repair or maintain qualified machinery, equipment or

other tangible personal property is includable in a prime contractor's tax base under the prime contracting classification.

EXAMPLES:

A contractor is performing actions that constitute an "improvement to real property."

If the contractor purchased, with or without an agency agreement, machinery or equipment that was exempt under A.R.S. § 42-5061(B) which was not permanently attached to the realty, then under A.R.S § 42-5061(B)(7) the contractor may deduct the labor portion of the contract from the contractor's gross income except for that portion of any contracting activity which consists of the development of, or modification to, real property in order to facilitate the installation, assembly, repair, maintenance or removal of machinery, equipment or other qualifying tangible personal property. The equipment cost will not be included in the gross income of the contractor.

If the contractor purchased machinery or equipment that was exempt under A.R.S. § 42-5061 (B), with or without an agency agreement, which was permanently attached to the realty, then under A.R.S § 42-5061(B)(9) the contractor cannot deduct the labor portion of the contract from the contractor's gross income. The equipment cost will not be included in the gross income of the contractor.

Mark W. Killian, Director
Signed: August 28, 2000

Explanatory Notice:
The purpose of a tax ruling is to provide interpretive guidance to the general public and to department personnel. A tax ruling is intended to encompass issues of law that are not adequately covered in statute, case law or administrative rules. A tax ruling is a position statement that provides interpretation, detail, or supplementary information concerning application of the law. Relevant statute, case law, or administrative rules, as well as a subsequent ruling, may modify or negate any or all of the provisions of any tax ruling. See GTP 96-1 for more detailed information regarding documents issued by the Department of Revenue.