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ARIZONA TRANSACTION PRIVILEGE TAX NOTICE

TPN 14-1

November 18, 2014

NOTE: This document addresses various questions and provides examples involving changes to the prime contracting classification for Arizona transaction privilege tax ("TPT"), as introduced by Laws 2014, chapter 263 (H.B. 2389). These changes take the place of any changes made by Laws 2013, chapter 255 (H.B. 2111) to A.R.S. §§ 42-5009 and 42-5075.

FAQs

Q1. Who is a contractor?

A1. A contractor has the same meaning as a "builder" and means a person or organization that 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 any building, highway, road, railroad, excavation, manufactured building, or other structure, project, development or improvement, or do any part of such project, including scaffolding or other structure or works in connection with such a project, and includes subcontractors and specialty contractors.

Q2. Who is required to obtain a TPT license under the prime contracting classification?

A2. Prime contractors must obtain TPT licenses and are subject to TPT under the prime contracting classification. A prime contractor is a person who performs, coordinates, or supervises modification work, including contracting with any subcontractors. The prime contractor is the person responsible for the completion of the contract. A prime contractor is subject to prime contracting TPT, regardless of whether the contractor furnishes only labor or both labor and materials in the performance of modification work.

Q3. Who is not required to obtain a TPT license under the prime contracting classification?

A3. A contractor is not required to obtain a prime contracting TPT license if its business activities are limited to contracts for the maintenance, repair, replacement, or alteration of existing property with either: (a) the owners of real property or (b) the owners of the improvements to real property. If a contractor performs modification contracts in addition to maintenance, repair, replacement, and alteration contracts, the contractor is subject to prime contracting TPT on its gross receipts from the modification contracts and is required to obtain a TPT license.

Q4. What are taxable modification activities, for purposes of the prime contracting TPT?

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A4. Taxable modification activities encompass construction, improvement, movement (including removal), wreckage, or demolition activities, to the extent that they cannot otherwise be characterized as maintenance, repair, replacement, or alteration activities. (See Q17 below for a discussion of the exception regarding de minimis modification activities.) Activities that fall within any of these latter four categories would not be subject to prime contracting TPT.

Q5. What are “maintenance”, “repair”, “replacement”, and “alteration” activities, which generally are not subject to prime contracting TPT?

A5. “Maintenance” is the upkeep of property or equipment. Examples of maintenance include: an annual system checkup that includes topping off any fluids, restaining a wood deck, and refinishing hardwood floors.

“Repair” is an activity that returns real property to a usable state from a partial or total state of inoperability or nonfunctionality. Examples of repairs include: recharging partially or totally nonfunctional air-conditioning units with refrigerant, clearing partially or completely blocked pipes of debris, readjusting satellite dishes to restore reception, and replacing worn washers in leaky or totally inoperable faucets.

“Replacement” is the act of replacing something that exists with something else, including the upgrading of existing systems. Examples of replacement include replacing an HVAC system that is no longer functioning at optimum levels with a new, more efficient unit or replacing a deteriorated shingled roof with a new one.

“Alteration” is an activity that causes a direct physical change to real property without causing a change in the identity of the real property. Examples of alterations include: enlarging a patio, sandblasting a building’s façade, and tamping railroad ties.

Materials purchased by a contractor for use in maintenance, repair, replacement, or alteration activities will generally be subject to retail TPT at the time of purchase, unless such purchases are otherwise exempt from retail TPT. For example:

- Materials purchased for use in constructing a hospital will be exempt from retail TPT at the time of purchase, because there is a retail TPT exemption for sales of tangible personal property to a hospital.
- Materials purchased for use in a maintenance, repair, replacement, or alteration activities performed on an Indian reservation will be subject to retail TPT at the time of purchase, because there is no applicable retail TPT deduction or exemption.

Q6. Who can be considered an “owner of real property” under the prime contracting classification?

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- A6.** An agent of the owner of real property, such as a property manager, would be treated as the owner for the purposes of prime contracting contracts. Similarly, any person with the authority to contract for modification, maintenance, repair, replacement, or alteration activities to be performed on the real property at issue will be treated as an owner under the prime contracting classification. If a contractor works under a prime contractor hired by a person considered an owner of real property, for the purposes of such contracts, the contractor is considered to be working for an agent of the owner.
- Q7.** Are materials that are incorporated into a construction project subject to TPT at the time of purchase?
- A7.** Materials purchased by a TPT-licensed contractor for incorporation into a construction project are not subject to retail TPT at the time of purchase from a retailer, because such projects are subject to prime contracting TPT. Absent another deduction under the retail classification, a contractor without a TPT license who is purchasing materials that are to be incorporated into a construction project subject to prime contracting TPT will be unable to purchase them exempt from retail TPT unless the contractor presents a valid Form 5009L exemption certificate issued by the Department for the project.
- Q8.** I am a contractor who only performs maintenance, repair, replacement, or alteration activities and will no longer be licensed as a prime contractor for TPT purposes after January 1, 2015. I currently have materials that I purchased exempt from retail TPT for incorporation into a construction project prior to the effective date of January 1, 2015. How should I treat these materials for TPT purposes?
- A8.** Assuming you purchased the materials tax-free before January 1, 2015 with the intent to incorporate them into a project that, before January 1, 2015, was subject to prime contracting TPT, your use of an exemption certificate to purchase the materials was proper. However, because the subsequent use of the materials on or after January 1 is for maintenance, repair, replacement, or alteration activities that are no longer subject to prime contracting TPT, you will be liable for the amount of the retail TPT for these materials. This amount will be based on your purchase price of the materials. Because the retail and prime contracting TPT structure in effect before January 1 did not require you to maintain information on the identity or location of the vendor in your books and records, these materials will be sourced to the location of your principal place of business in Arizona, for the purposes of TPT liability, reporting, and payment.

As part of proper recordkeeping, you should list all materials on hand as of January 1, 2015 that were acquired exempt from retail TPT. You will be deemed to use these materials over a twelve-month time period on a prorated basis, regardless of whether you actually use these materials within this period. Consequently, you will report and pay the amount of retail TPT on one-twelfth of the total purchase price of all materials on hand as of January 1

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each month, beginning with the January 2015 reporting period and ending with the December 2015 reporting period.

Q9. I am a contractor who will remain licensed for prime contracting TPT purposes after January 1, 2015 because I will continue to perform taxable modification activities. Nevertheless, I will also perform nontaxable maintenance, repair, replacement, or alteration activities as part of my business. The performance of these nontaxable activities requires some or all of the same materials I acquire for taxable modification activities. I currently have materials that I purchased exempt from retail TPT for incorporation into a construction project prior to the effective date of January 1, 2015. How should I treat these materials—and materials I subsequently acquire—for TPT purposes?

A9. As in Q8/A8 above for a contractor who will no longer be licensed after January 1, 2015, you will need to prepare a list of materials on hand as of January 1. When you use these materials in nontaxable maintenance, repair, replacement, or alteration activities, you will report the retail TPT due on them, sourcing the materials to the location of your principal place of business in Arizona for the purposes of TPT liability, reporting, and payment. The tax should be reported and remitted in the reporting period in which you receive the last receipts arising from the project. Reporting in this manner will allow for reconciliation to account for any unused materials at the end of the project.

For materials acquired after January 1, 2015, you should track the use of materials toward taxable or nontaxable projects as part of your business's requisition-costing procedure for determining what materials get charged to a particular project. You may only use Arizona Form 5000 when purchasing materials to be incorporated into a construction project. If materials acquired exempt from retail TPT under Arizona Revised Statutes ("A.R.S.") § 42-5061(A)(27) are incorporated into a nontaxable maintenance, repair, replacement, or alteration, pursuant to A.R.S. § 42-5009(D), the amount of retail TPT that would have been due at the time of purchase (along with applicable penalty and interest) should be remitted in the reporting period in which you receive the last receipts arising from the project. All materials acquired after January 1, 2015 should be likewise sourced to your principal place of business in Arizona.

Penalty and interest will begin to accrue from the abovementioned reporting period.

Q10. I am a taxable prime contractor. What do I need to do if I hire a contractor without a TPT license as a subcontractor on a taxable project?

A10. A prime contractor who hires one or more contractors who do not have TPT licenses must obtain a project-specific exemption certificate—the Form 5009L exemption certificate—from the Department of Revenue that will provide the documentation necessary to allow the contractors to purchase materials to be incorporated into the taxable prime contracting project exempt from tax.

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Q11. If I am a taxable prime contractor and hire a contractor who is not licensed as a prime contractor for TPT purposes as a subcontractor on a nontaxable project, does it affect the taxability of my gross receipts derived from the project?

A11. No. The prime contractor's gross receipts derived from the subcontracted activity continue to be nontaxable for prime contracting TPT purposes.

Q12. What if I am not required to have a TPT license but will be working for a licensed contractor on a taxable project? Can I buy my materials exempt from TPT?

A12. A contractor without a TPT license who is working for a taxable prime contractor should obtain a copy of the approved certificate (Form 5009L) the prime contractor has received from the Department of Revenue to provide to the retailer so that materials may be purchased for the taxable project exempt from retail TPT. The unlicensed contractor cannot use a Form 5000 in place of the Form 5009L.

Q13. What is the procedure for a prime contractor to obtain an exemption certificate to issue to its subcontractors who do not have TPT licenses?

A13. A prime contractor who hires unlicensed contractors to work as subcontractors on a taxable project must first obtain a project-specific exemption certificate from the Department of Revenue to issue to its subcontractors, so that the subcontractors may purchase materials to be incorporated into the project exempt from retail TPT. The prime contractor must submit the following documents to obtain the approved certificate:

1. A completed Form 5009L that contains the following information:
 - a. The prime contractor's name, address, transaction privilege tax number, Arizona Registrar of Contractors' license number, the date the project will begin, and the estimated date of completion.
 - b. A list of the unlicensed contractors hired as subcontractors, including their names and Arizona Registrar of Contractors' license numbers.
 - c. A description of the project.
2. A copy of the contract with the owner.

Send completed requests to the following address:

ATTN: Form 5009L Request
Tax Research & Analysis Section
1600 W. Monroe St. – Division Code 3
Phoenix, AZ 85007-2650

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The prime contractor may amend the list of contractors without TPT licenses who are hired as subcontractors after issuance of a Form 5009L for a project by filing a request with the Department at any time.

- Q14.** How long is a Form 5009L exemption certificate valid?
- A14.** The Form 5009L exemption certificate issued pursuant to A.R.S. § 42-5009(L) is valid for the term of the project.
- Q15.** I am a contractor who will remain licensed as a prime contractor for TPT purposes after January 1, 2015. Before January 1, I had supplied my suppliers with Form 5000s and subcontractors with Form 5005s, many of which are “blanket” (*i.e.*, not project-specific). What should I do after this date to comply with the law?
- A15.** If you hold a TPT license for prime contracting purposes after January 1, 2015, you can continue to use a non-project specific Form 5000 to purchase materials intended for incorporation into construction projects from a retailer. While you can continue to supply a Form 5005 to a subcontractor who holds a TPT license for prime contracting purposes, you must use a Form 5009L with any subcontractor who does not hold such a license. A 5009L must be issued by the Department and will be project-specific.
- Q16.** What if a contract includes both replacement activity and modification activity? (Modification activity is generally subject to prime contracting TPT.)
- A16.** Unless the modification activity meets the de minimis test, the entire contract is subject to prime contracting TPT.
- Q17.** What does it mean to have de minimis modification activity in a nontaxable contract?
- A17.** A modification will be considered “de minimis” if the amount attributable to the modification is less than 15% of receipts from the total contract. If the modification is less than 15% of receipts from the total contract, the Department will interpret de minimis modification as being of such an inconsequential nature as to be nontaxable, rendering receipts from the entire contract exempt from prime contracting TPT.

Please note that taxable modification activities will be considered in the de minimis calculation, regardless of the reasons for which such activities are performed and what role they have in performing nontaxable maintenance, repair, replacement, or alteration activities. For example, when existing construction is demolished as part of a nontaxable alteration and earth is removed as part of construction for an underground garage as part of a single project, both demolition and removal activities will be considered part of taxable modification activities, for the purposes of determining the percentage of total gross receipts derived from the contract that are attributable to modification activity.

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Q18. How does a change order affect the taxability of a nontaxable contract?

A18. A change order is considered to be a separate contract. If the change order is for modification activity that is subject to TPT, the entire change order is subject to TPT. The taxability of a change order does not impact the taxability of the original contract. For example, suppose a contractor has a contract to expand the size of an existing building. The contract for expansion is an alteration and is not subject to TPT. During the course of the work, however, suppose the customer decides to construct a new building in addition to the expansion of the existing one, and the change in the contract is done through a "change order." The construction of the new building is subject to prime contracting TPT. The taxability of the contract made through the change order, however, does not also make the initial contract for the alteration of the existing building subject to TPT. Each contract is independent of the other.

Examples of specific scenarios

1. *Scenario:* A homeowner decides to remodel her kitchen. The owner hires a contractor and has him replace all of the existing appliances and flooring. Additionally, the homeowner decides to have the contractor install a new island that did not previously exist.

Result: This contract is not subject to prime contracting TPT. The addition of the kitchen island is an alteration that, along with the replacements made, is exempt from TPT. The materials to be used in this contract are subject to retail TPT.

2. *Scenario:* A business has an existing pump system in its building. One day, the pump fails. The business owner hires a contractor to repair the pump. The contractor replaces the existing faulty pump with a fully operating one. While on the job, the contractor notices that the wiring leading up to the pump also needs to be replaced. The contractor replaces this wiring.

Result: This contract is for replacement activity and thus not subject to prime contracting TPT. The materials to be used in this contract are subject to retail TPT.

3. *Scenario:* A business hires a contractor to install a pump system in its building. Before installation, the building did not have a pump system.

Result: The installation of the pump system is an alteration to real property that is exempt from prime contracting TPT. The materials to be used in this contract are subject to retail TPT.

4. *Scenario:* As part of the renovation of her house, a homeowner hires a contractor to: remove and replace electrical panels, an automatic transfer switch, and a backup generator; install new wiring and conduit; and alter existing conduit.

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Result: The contract is for repair, replacement, and alteration activities only and thus is not subject to prime contracting TPT. The materials to be used in the contract are subject to retail TPT.

5. *Scenario:* A business intends to remodel its retail storefront. It begins by hiring a contractor to demolish the store's existing interior walls and remodel the store.

Result: Demolition and debris removal are taxable modification activities, while remodeling activities are generally nontaxable activities, for purposes of prime contracting TPT. The de minimis test must be applied to determine what percentage of the remodel contract is for demolition and removal. If they account for more than 15% of the total contract, the entire contract is subject to prime contracting TPT; if they account for less than 15% of the total contract, however, they are considered de minimis, and the contract is exempt from prime contracting TPT.

6. *Scenario:* A business that sells sheds for a single lump-sum price provides the sheds to customers through a subcontractor that delivers and installs the sheds on customers' sites. The subcontractor either delivers and installs a prefabricated shed or assembles and installs it onsite. In either case, the shed will be installed on a concrete pad or piers.

Result: If there is no preexisting concrete pad or piers at the customer's site, the sale and installation of the shed will be subject to prime contracting TPT, with the setup site as the taxable situs under A.R.S. § 42-5075(M)(1). If the subcontractor installs the shed on an existing pad or piers, however, the installation will constitute a nontaxable alteration activity, and retail TPT will be due on the sale of the prefabricated shed or materials.

7. *Scenario:* A business owner has an existing A/C system in their building. The business owner has a contractor inspect the A/C system annually. On the most recent visit, the contractor discovers that the system's Freon level is low and recharges it.

Result: This contract is for maintenance activity and thus not subject to prime contracting TPT. The materials to be used in this contract are subject to retail TPT.

8. *Scenario:* A business hires a contractor to build new concrete ramps and sidewalks connecting buildings on its campus where none existed before. As part of the same contract, the contractor also is responsible for removing and replacing any existing concrete sidewalks and paved curtilage around its buildings.

Result: The pouring of new sidewalks and ramps where none existing previously is generally subject to prime contracting TPT, as is the demolition and removal of the existing concrete. The replacement of the existing sidewalks and pavement, however, is generally a nontaxable replacement activity, with sales of materials used in the replacement activities subject to retail TPT. Because the contractor is responsible for performing these two categories of activities for

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the project, the de minimis test must be applied to determine what percentage of the contract is for the pouring of new sidewalks and ramps and demolition and removal of existing concrete structures. If they account for more than 15% of the total contract, the entire contract is subject to prime contracting TPT; if they account for less than 15% of the total contract, however, they are considered de minimis and receipts from the contract are exempt from prime contracting TPT.

9. *Scenario:* As part of a flood control measure, the state awards a contract for the refurbishment of an existing dam. As part of the refurbishment project, the contractor is responsible for raising the height of the existing structure, thereby increasing its size and flood retention capacity. The project also includes clearing, cleaning, and adding water diversion materials to already existing drainage channels.

Result: Raising the height of an existing dam is a nontaxable alteration, while the draining channel work constitutes a nontaxable repair activity. As such, the contract is not subject to prime contracting TPT.

10. *Scenario:* A plumbing subcontractor is working on a project that originally involved 80% repair work and 20% new construction. Because of numerous change orders, the amount of work performed for the new construction grew to 60% of the scope of the work.

Result: Because the work related to the new building addition is greater than 15%, the entire contract would be subject to prime contracting TPT. A change order is considered a separate contract and does not impact the taxability of the original contract. Consequently, each change order would need be evaluated independent of the original contract and the other change orders. If the work for a particular change order involves modification activities that do not otherwise constitute maintenance, repair, replacement, or alteration, the change order is subject to prime contracting TPT. If the work involves maintenance, repair, replacement, or alteration activities, the change order is not subject to prime contracting TPT, but the materials are subject to retail TPT.

11. *Scenario:* A homeowner decides to build a *new* block wall (no existing structure prior) in his backyard to separate his yard from his neighbor's. The completed new wall does not have stucco or paint on it. A month later, the homeowner hires a different contractor to stucco and paint the wall.

Result: The contract to build the new block wall is for modification activity subject to prime contracting TPT. The subsequent contract to stucco and paint the wall is for alteration activity and thus not subject to TPT, regardless of whether this contract is with the original contractor or a different contractor.

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12. *Scenario:* A homeowner decides to have an outdoor kitchen installed in her backyard. The new kitchen will be freestanding and will not be attached to an existing structure (e.g., a patio or existing concrete slab); there is only grass now where the kitchen is to be installed.

Result: The contract to install a new outdoor kitchen is for modification activity and thus will be subject to prime contracting TPT.

13. *Scenario:* A homeowner buys a shed at a home improvement store. This shed is prefabricated prior to purchase. The homeowner hires a contractor for the installation of this shed. The contractor bolts the shed to an existing slab of concrete that the same contractor installed under a different contract. During the installation of the shed, the contractor installs lighting inside and runs water and electrical lines to the slab to service the shed.

Result: Because there is a preexisting concrete slab, the installation of the shed and interior lighting are nontaxable alteration activities and are thus not subject to prime contracting TPT, and the sale of the shed would be subject to retail TPT. Because the running of the water and electrical lines is taxable modification activity, however, the de minimis test must be applied to the contract. If the modification activity accounts for more than 15% of the total contract, the entire contract is subject to prime contracting TPT; if it accounts for less than 15% of the total contract, however, the activity will be considered de minimis and receipts from the contract are exempt from prime contracting TPT. If there were no preexisting structure on the concrete pad or piers at the customer's site, the sale of the shed will be subject to prime contracting TPT, with the setup site as the taxable situs under A.R.S. § 42-5075(M)(1), with the lighting installation and gas and electrical line extension being taxable modification activities as well.

14. *Scenario:* As part of the maintenance of deteriorating roadway concrete, the state hires a contractor to demolish and remove the existing concrete and replace it with an improved material, as well as applying a new type of road striping that did not exist when the original roadway was built.

Result: Demolishing and removing the old roadway concrete is modification activity, which the application of new concrete and striping is repair and replacement that is generally not subject to prime contracting TPT. The de minimis test must be applied to the contract. If the demolishing and removal activities account for more than 15% of the total contract, the entire contract is subject to prime contracting TPT; if they account for less than 15% of the total contract, however, they are considered de minimis and receipts from the contract are exempt from prime contracting TPT.

15. *Scenario:* A contractor is responsible for improving 27 miles of roadway. The existing condition is a signed (i.e., numbered) dirt roadway; upon project completion, the road structure will consist of aggregate base and asphaltic concrete, the road will have a new storm drain, and the road will be upgraded from a single road into a divided roadway.

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Result: Because the original dirt roadway constitutes improved real property, the road improvement generally consists of alteration activities exempt from prime contracting TPT. If demolishing and removal activities must be performed, the de minimis test must be applied to the contract. If such activities account for more than 15% of the total contract, the entire contract is subject to prime contracting TPT; if they account for less than 15% of the total contract, however, they are considered de minimis and receipts from the entire contract are exempt from prime contracting TPT.

Please note that the roadway in this example was already improved real property prior to alteration, insofar as it was an official signed roadway. Regardless of whether it is public or private, modification performed on a right-of-way that is *not* considered improved will generally be subject to prime contracting TPT (*e.g.*, a dirt path to transmission lines that is distinguishable from the surrounding land merely because it is worn down by regular utility truck use).

16. *Scenario:* A contractor is responsible for building a pedestrian and bicycle pathway along an existing wash channel. The wash has been previously improved with excavation, clearing, and soil cement along the channel walls for strengthening and erosion control purposes. The pathway project will consist of expanding the area of existing soil cement up over the shoreline to allow for pedestrian and bicycle access.

Result: Because the original wash channel constitutes improved real property, the pathway project generally consists of alteration activities exempt from prime contracting TPT. If demolishing and removal activities must be performed, the de minimis test must be applied to the contract. If such activities account for more than 15% of the total contract, the entire contract is subject to prime contracting TPT; if they account for less than 15% of the total contract, however, they are considered de minimis and receipts from the entire contract are exempt from prime contracting TPT.

17. *Scenario:* A contractor is engaged to convert a 20,000-square foot warehouse into an indoor go-cart racing facility. In addition to reconfiguring the interior to provide for a racetrack and other recreational amenities, conversion will enlarge the existing warehouse structure to 30,000 square feet, expanding the interior to cover what is currently raw land adjacent to the warehouse as well as a portion of a parking lot.

Result: Because all activities are performed on existing improved real property, the conversion project will generally consist of alteration activities that are exempt from prime contracting TPT. If demolishing and removal activities must be performed, the de minimis test must be applied to the contract. If such activities account for more than 15% of the total contract, the entire contract is subject to prime contracting TPT; if they account for less than 15% of the total contract, however, they are considered de minimis and receipts from the entire contract are exempt from prime contracting TPT.

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Explanatory Notice

The purpose of a tax notice is to provide general guidance to assist taxpayers in becoming familiar with Arizona tax laws. A tax ruling is intended to encompass issues of law that are not adequately covered in statute, case law or administrative rules, but are not intended to address complex issues in detail or to address a taxpayer's specific circumstance. Relevant statute, case law, or administrative rules, as well as a subsequent notice, may modify or negate any or all of the provisions of any tax notice. If the information in a notice is shown to be erroneous and a taxpayer shows reasonable reliance on that information, the taxpayer will be liable for any tax or interest which may result from the erroneous advice, but no penalties will be imposed. See GTR 08-1 for more detailed information regarding documents issued by the Department of Revenue.