

# STATE OF ARIZONA

Department of Revenue  
Office of the Director  
(602) 716-6090



Janice K. Brewer  
Governor

Gale Garrriott  
Director

**CERTIFIED MAIL [redacted]**

**The Director's Review of the Decision  
of the Administrative Law Judge Regarding:** )  
 )  
**[REDACTED]** )  
 )  
**ID No. [redacted]** )  
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**ORDER**

**Case No. 200900009 - S**

On January 4, 2010, the Administrative Law Judge (“ALJ”) issued a decision (“Decision”) regarding the protest of [redacted] (“Taxpayer”). The Transaction Privilege and Use Tax Section in the Audit Division (“Division”) of the Department of Revenue (“Department”) and the Taxpayer both appealed this Decision on February 3, 2010. As the appeals were timely, the Director (“Director”) of the Department issued a notice of intent to review the Decision.

In accordance with the notice given the parties, the Director has reviewed the ALJ's Decision and now issues this order.

### STATEMENT OF CASE

Taxpayer requested a refund of transaction privilege tax paid under the prime contracting classification for the period of February 1, 2001 through August 31, 2002 (“Period”), for the construction of a [redacted] pipeline and related items. The Division determined that the laying of pipeline was a taxable contracting activity and denied Taxpayer’s refund claim. Taxpayer protested the refund denial, and the matter went to hearing. The ALJ granted the refund request and protest in part, pending support of amounts determined exempt, and denied it in part, reversing in part and affirming in part the Division’s refund denial.

On appeal, Taxpayer argues that it is entitled to the entire requested refund. The Division argues that the refund denial was proper under the circumstances.

### FINDINGS OF FACT

The Director adopts from the findings of fact in the Decision of the ALJ and makes additional findings of fact based on the record as set forth below:

1. Taxpayer is a pipeline construction company headquartered in [redacted].
2. In 2001, Taxpayer entered into two contracts (“Contracts”) with a pipeline owner and operator (“Owner”) to install [redacted] pipeline and associated equipment in two projects in Arizona.
3. For the first project, under a contract dated [redacted], Taxpayer installed approximately [redacted] pipe and [redacted] of [redacted] pipe for a segment of [redacted] in Arizona.
4. For the second project, under a contract dated [redacted], Taxpayer converted an old [redacted] pipeline, which [redacted] the State of Arizona [redacted], to a [redacted] pipeline. Taxpayer removed old above-ground piping assemblies that connect to the buried pipeline, installed new segments of pipeline, made required modifications to the old pipeline, and repaired and replaced valves and other components of the pipeline system.
5. For both Contracts, Owner supplied the piping, valves and other pipeline components.
6. The installation of new segments of pipeline, for both Contracts, involved clearing and grading the land along the proposed routes, excavating trenches, “padding” the trenches with dirt, hauling the pipe to the installation site, assembling and installing the pipe by welding it together, applying a protective coating, backfilling the trenches and restoring the land with grasses or small native plants.
7. Taxpayer buried the pipeline at a trench depth of [redacted] feet.
8. Third-parties, [redacted], and the State of Arizona own the land through which the pipeline routes run. The land owners permit Owner to install the pipeline on their

land under right-of-way easements. The easements, which grant the use of a strip of land, are made for 50 or more years or in perpetuity.

9. Those of Owner's right-of-way easements, that are not made in perpetuity, provide for a removal of the equipment upon termination of the right-of-way.
10. Buildings and large trees are usually not allowed in the right-of-way along and above the pipeline, and Owner can access the pipeline for repairs by reopening the trenches.
11. Occasionally in the past, and unrelated to the Contracts with Taxpayer, Owner had portions of other pipeline segments removed, abandoned in place, replaced or relocated to accommodate land development or for other reasons.
12. There is no evidence that Owner contemplated a specific time in the future when the pipelines that Taxpayer installed would be removed or reconfigured, or that any such removal or reconfiguration actually took place.
13. Taxpayer collected, reported and paid Arizona transaction privilege tax under the prime contracting classification on its receipts from the Contracts.
14. In January 2005, Taxpayer filed a refund claim for [redacted] of transaction privilege tax, plus interest, for the Period. Taxpayer has declared that it would pass on any refund of the tax to Owner.
15. The Division denied the refund claim and the matter went to hearing.
16. The ALJ determined that the pipe and associated equipment were qualified tangible personal property and were not permanently attached to the real property.
17. The ALJ concluded that a portion of Taxpayer's income from the Contracts remained taxable because it was from construction activity that "facilitated" the installation of the pipe and associated equipment, and that this activity consisted of clearing and grading the right-of-way, creating and "padding" the trench, backfilling the trench, any re-excavation, repairs and recovering of pipe needing repair, restoring of the

land surface, removing above-ground old “pigging” equipment and removing and replacing above-ground valves.

18. The ALJ further concluded that nontaxable activity under A.R.S. § 42-5075(B)(7) consisted of hauling the items to the site, the above-ground assembling of pipe units, testing, repairing and coating of the pip welds, lowering the assembled pipe into the trench, and water-pressure testing of the pipeline, but that Taxpayer had not demonstrated which portions of the remitted taxes were attributable to these activities, and that, in the absence of supporting documentation, the income from those activities remained taxable.
19. Taxpayer appealed the ALJ’s Decision insofar as it treats the removal of old above-ground “pigging” facilities, the removal and replacement of above-ground valves, and the work to repair pipeline after pressure testing in conjunction with initial pipeline installations as taxable activities. Taxpayer is not challenging the ALJ’s Decision with regard to the other activities held taxable construction activity that “facilitated” the installation of the pipe and associated equipment.
20. The Division appealed the ALJ’s Decision to the extent that it holds that the pipe does not become a permanent attachment.

### **CONCLUSIONS OF LAW**

The Director adopts from the conclusions of law in the Decision of the ALJ and makes additional conclusions of law as follows:

1. A.R.S. § 42-5075 (“prime contracting classification”) imposes transaction privilege tax on the business of prime contracting, which includes the construction, alteration, repair, addition, subtraction, improvement, movement, wreckage or demolition of buildings, roads, excavations, structures, projects, developments and improvements.
2. Taxpayer engaged in the prime contracting business in Arizona when it performed pipeline construction under the Contracts with Owner.

3. A.R.S. § 42-5061(B)(6) provides an exemption from retail transaction privilege tax for gross proceeds of sales or gross income derived from sales of “[p]ipes or valves four inches in diameter or larger used to transport oil, natural gas . . . , including . . . machinery and equipment, . . . and any other part that is used in operating the pipes or valves.”
4. Under both Contracts, Taxpayer installed pipes four inches in diameter or larger and associated equipment items that are exempt from retail transaction privilege tax under A.R.S. § 42-5061(B)(6), as conceded by the Division.
5. A.R.S. § 42-5075(B)(7) provides an exemption from transaction privilege tax for gross proceeds of sales or gross income derived from the installation, assembly, repair or maintenance of machinery, equipment or other tangible personal property that is deducted from the tax base of the retail classification under A.R.S. § 42-5061(B) and that is not permanently attached to real property.
6. A.R.S. § 42-5075(B)(7) provides that “[i]f the ownership of the realty is separate from the ownership of the machinery, equipment or tangible personal property, the determination as to permanent attachment shall be made as if the ownership were the same.”
7. The deduction provided in A.R.S. § 42-5075(B)(7) does not include proceeds from the development of, or modification to, real property in order to facilitate the exempt equipment installation.
8. A.R.S. § 42-5075(B)(7) defines “permanent attachment” to real property as meaning at least one of the following:
  - (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 be so attached to real property that removal would cause substantial damage to the real property from which it is removed.

9. Tangible personal property that is combined into, or embedded in, the real property is incorporated into real property.
10. The right-of-way easements, granting Owner the right to install pipelines on land owned by others, are interests in real property.
11. The exempt pipes and associated equipment that Taxpayer installed for Owner under both Contracts are incorporated into real property within the meaning of A.R.S. § 42-5075(B)(7)(a).
12. The common law of fixtures employs a three-prong test to determine whether tangible personal property becomes a fixture: (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. (3) There must be an intention of the party to make the chattel a permanent accession to the freehold. The pipelines that Taxpayer installed under the Contracts meet all three prongs of this test.
13. An item of personal property becomes a fixture if a reasonable person, after considering all the relevant circumstances, would assume that the item in question belongs to and is a part of the real estate on which it is located. *Arizona Department of Revenue v. Arizona Outdoor Advertisers, Inc.*, 202 Ariz. 93, 96, 41 P.3d 631, 634 (App. 2002).
14. The installed and buried pipelines are reasonably assumed to be a part of the right-of-way on which they are located and are affixed to real property within the meaning of A.R.S. § 42-5075(B)(7)(b).
15. The installed pipes and associated equipment became permanently attached to real property.
16. Taxpayer's proceeds derived from the Contracts do not qualify for the exemption from transaction privilege tax provided in A.R.S. § 42-5075(B)(7).

## DISCUSSION

Taxpayer is requesting the review of the ALJ's Decision insofar as it concerns the removal of old above-ground "pigging" facilities, the removal and replacement of above-ground valves, and the work to repair pipeline after pressure testing in conjunction with initial pipeline installations are taxable activities. Taxpayer argues that those activities are modifications to personal property and not to real property, and that they are not excluded from the exemption provided in A.R.S. § 42-5075(B)(7). Taxpayer also argues that the ALJ's determination that the pipeline is not permanently attached to real property under A.R.S. § 42-5075(B)(7) should be affirmed.

The Division requests that the ALJ's Decision be reversed to the extent that the Decision does not consider the pipelines permanently attached to real property, and that Taxpayer's refund claim be denied. The Division argues that the pipeline meets all three alternative tests in A.R.S. § 42-5075(B)(7) for a permanent attachment to real property. The Division further argues that the activities that are the subject of Taxpayer's appeal should be found taxable.

Under the Contracts, Taxpayer constructed pipeline sections and buried them underground. Thus, Taxpayer's proceeds from pipeline construction under the Contracts are proceeds from the construction, alteration, repair and improvement of excavations and other projects, development or improvements that qualify as the business of prime contracting within the meaning of the prime contracting classification of A.R.S. § 42-5075.<sup>1</sup>

A.R.S. § 42-5075(B)(7) provides an exemption from transaction privilege tax for "gross proceeds of sales or gross income . . . derived from . . . the installation, assembly, repair or maintenance of machinery, equipment or other tangible personal property that is deducted from the tax base of the retail classification . . ." under A.R.S. § 42-5061(B) . . . "and that

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<sup>1</sup> Based on Taxpayer's submissions, it is not entirely clear whether Taxpayer concedes that its construction activities, such as trenching and burying the pipelines, are prime contracting. Taxpayer did not appeal the ALJ's Decision insofar as it applies the prime contracting classification and excludes Taxpayer's activities of clearing, grading, trenching, backfilling and re-excavating from the exemption in A.R.S. § 42-5075(B)(7). Yet, Taxpayer wishes to reserve the argument that its entire proceeds from the Contracts are not taxable.

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does not become a permanent attachment to a building, highway, road, railroad, excavation or manufactured building or other structure, project, development or improvement. Proceeds from “the development of, or modification to, real property in order to facilitate” the exempt equipment installation are excluded from the exemption.

It is undisputed that the pipes and associated equipment installed under both Contracts are pipes or valves four inches in diameter or larger used to transport [redacted] and equipment used in operating the pipes, items which are exempt from transaction privilege tax under the retail classification pursuant to A.R.S. § 42-5061(B)(6). The issues are whether the pipelines became a permanent attachment to real property and, if the pipelines are not permanently attached, whether the activities addressed in Taxpayer’s appeal are excluded from the exemption in A.R.S. § 42-5075(B)(7) as “the development of, or modification to, real property in order to facilitate” exempt activities.

Under A.R.S. § 42-5075(B)(7), property becomes a permanent attachment if it is “incorporated into real property,” if it becomes “so affixed to real property that it becomes a part of the real property,” or if it 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 these 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.

To be “incorporated into real property” within the meaning of A.R.S. § 42-5075(B)(7)(a) implies a physical combination into the real property. Taxpayer buries the pipelines underground in trenches that are backfilled, and the land is restored to an even surface covered by grasses or other plants. The pipelines are thus embedded into the land. The Division points to the Arizona Court of Appeals’ decision in *Centric-Jones Co. v. Town of Marana*, 188 Ariz. 464, 937 P.2d 654 (App. 1996) for a definition of “incorporation” with regard to installed pipes. There, one of the issues was whether the installation of water pipes and valves of four inches in diameter or larger in a pumping station was taxable



prime contracting or an exempt retail sale. Citing *Duhamel v. State Tax Commission*, 65 Ariz. 268, 278-79, 179 P.2d 252, 262-63 (1947), the court stated:

When a contractor fabricates his materials for the contractee, and the completed structure is erected on the owner's land, it is as much real property as the land itself. The constituent elements of tangible personal property have been destroyed by their incorporation into the completed structure.

*Centric-Jones*, 188 Ariz. at 478, 937 P.2d at 668. The court concluded that the pipes and valves were not sold separately from the construction contract but were incorporated into the completed pumping station and became “part and parcel of that real estate.” *Id.*

Taxpayer argues that the pipeline does not support or serve the real estate, and that it is not incorporated into real property because it has no unity of function and purpose with the real estate it traverses. However, the pipeline is installed on land for which easements were granted and serves the very purpose of those easements. Owner was granted long-term and perpetual right-of-way easements to construct and operate the pipelines and thus to have them incorporated into the real property for as long as the easement exists. An easement is the right of a person to use the real property of another for a specific purpose. See *A Tumbling-T Ranches v. Flood Control Dist. of Maricopa County*, 222 Ariz. 515, 541, 217 P.3d 1220, 1246 (App. 2009), *Siler v. Ariz. Dep't of Real Estate*, 193 Ariz. 374, 383, 972 P.2d 1010, 1019 (App. 1998), *Etz v. Mamerow*, 72 Ariz. 228, 231, 233 P.2d 442, 444 (1951). The easements are interests in real property.<sup>2</sup> They allow for the physical incorporation of the pipelines into that real property. The pipelines are therefore incorporated into the completed project.

Under the second alternative definition in A.R.S. § 42-5075(B)(7) of a permanent attachment, a piece of property that becomes “so affixed to real property that it becomes a part of the real property” is permanently attached. A.R.S. § 42-5075(B)(7)(b). Affixation to real property refers to the law of fixtures. The longstanding common law of fixtures employs

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<sup>2</sup> See *Atlantic & P.R. Co. v. Lesueur*, 2 Ariz. 428, 430, 19 P. 157, 158-159 (1888), an early Arizona case in which the court specifically states that right-of-way easements imply an interest in the land and are real property.

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a three-prong test to determine whether tangible personal property becomes real property or retains its identity as personalty. For chattel to become a fixture and be considered real property, three requisites must unite: (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; (3) there must be an intention of the party to make the chattel a permanent accession to the freehold. See, e.g., *Fish v. Valley Nat'l Bank*, 167 P.2d 107, 111 (Ariz. 1946); see also *Sulphur Springs Valley Elec. Co-op., Inc. v. City of Tombstone*, 401 P.2d 753, 758-59 (Ariz. Ct. App. 1965).

For purposes of determining whether an item of personal property has become a fixture, the Arizona Court of Appeals applied a “reasonable person test” in *Arizona Department of Revenue v. Arizona Outdoor Advertisers, Inc.*, 202 Ariz. 93, 41 P.3d 631 (App. 2002) and held that this test applies in the context of characterizing property as real or personal for tax purposes. The court stated that test as follows:

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?

*Arizona Outdoor Advertisers*, 202 Ariz. at 99, 100, 41 P.3d at 637, 638. The court explained that the three-part fixture test would no longer limit the inquiry but would continue to play a major role, with annexation as the triggering event for most fixtures inquiries.

Pipeline that is buried in the ground is annexed to the right-of-way, which is an interest in realty. See *Transcontinental Gas Pipe Line Corp. v. Prince William County*, 210 Va. 550, 556, 172 S.E.2d 757, 762 (Va. 1970) (concerning gas mains), *Waterford Energy, Inc. v. Oklahoma Tax Commission*, 845 P.2d 198, 200 (Okla. Ct. App. 1992) (concerning a gas-gathering pipeline.)

As for the adaptability to the use of the real estate, again, the pipeline serves the purpose for which the easements were created. Courts in other jurisdictions have applied this part of the fixtures test to pipelines with varying results. In *Waterford*, the Oklahoma Court of Appeals found that the pipeline benefited the company owning the right-of-way, not the

surface owner, and that the pipeline was adapted to the use of the right-of-way and enhanced its value, but was not connected with the general use of the surface as farmland. *Waterford*, 845 P.2d at 200. Citing *Waterford*, the Maryland Court of Appeals concluded that a petroleum pipeline was not accessory to the landowner's enjoyment of the land, that the pipeline existed to benefit the pipeline company's business interests exclusively, and that it did not meet the fixtures test. *Colonial Pipeline Company v. State Department of Assessments and Taxation*, 371 Md. 16, 38-39, 806 A.2d 648, 661 (Md. 2002). The Supreme Court of Appeals of Virginia, however, found that gas mains were adapted to the use of the property to which they were annexed, were essential to the purpose for which easements were acquired and used, and met all three prongs of the fixtures test. See *Transcontinental*, 210 Va. at 556, 172 S.E.2d at 762. For purposes of A.R.S. § 42-5075(B)(7), it is important to note that the exemption specifically provides that the determination as to permanent attachment, in situations where the ownership of the realty is separate from the ownership of the installed property, "shall be made as if the ownership were the same." The distinction between a benefit to the owner of the right-of-way and a benefit to the fee owner, which entered into the courts' analysis in *Waterford* and *Colonial Pipeline*, is therefore not relevant here. Without that distinction, the pipeline is no less adapted to the use of the land in which it is buried than any commercial property that leaves room and allows for other, additional uses of the same real estate.

Also, if the relationship to the fee owner's use of the land surface was a distinguishing factor here, as Taxpayer suggests, a pipeline that runs on an easement through one parcel of land and ends on an easement on a neighboring parcel to deliver the gas for use there could be a fixture, and thus permanently attached, on the neighboring property but not on the first parcel. This would be true even if there were otherwise no difference between the sections of pipeline and their installation. It is unlikely that the exemption in A.R.S. § 42-5075(B)(7) was intended to produce such an inconsistent result. The pipeline is adapted to the use of the easements and, therefore, to the use of the land on which the easements were granted.

As in *Transcontinental*, Owner has long-term rights-of-way, and the possibility that the pipeline may be removed at some point in the future does not stand in the way of the conclusion that the pipes were intended to become a part of the realty for the duration of their useful life. Almost any addition to real property is removable in theory, and any right-of-way easement that is not perpetual may be extended by agreement. There is no evidence that Owner or Taxpayer contemplated a specific time in the future when the pipeline would be removed or reconfigured, or that any such removal or reconfiguration actually took place.

The pipelines, therefore, meet all three prongs of the traditional fixtures test. In accordance with the “reasonable person test” of *Arizona Outdoor Advertisers*, the pipelines would also reasonably be assumed to belong to and be a part of the real property on which they are located upon installation under the ground. The pipelines are therefore so affixed to real property that they become a part of the real property within the meaning of the second alternative in the permanent attachment definition of A.R.S. § 42-5075(B)(7).

Finally, property can also become permanently attached within the meaning of A.R.S. § 42-5075(B)(7) if it is “so attached to real property that removal would cause substantial damage to the real property from which it is removed.” Although the pipelines remain accessible in the right-of-way, their removal would require excavation that would cause some damage to the real property. Whether that damage would be substantial with regard to the real property and the surface covering the pipelines does not determine the outcome of this matter, as the pipelines already meet the first and the second alternatives of the permanent attachment definition in A.R.S. § 42-5075(B)(7).

The pipelines became a permanent attachment to real property and, as a result, Taxpayer’s proceeds derived from the Contracts do not qualify for the exemption provided in A.R.S. § 42-5075(B)(7). It is therefore not necessary to determine whether the activities addressed in Taxpayer’s appeal develop or modify real property in order to facilitate pipeline installation.

**ORDER**

The Division's refund denial is affirmed.

This decision is the final order of the Department of Revenue. Taxpayers may contest the final order of the Department in one of two manners. Taxpayers may file an appeal to the State Board of Tax Appeals, 100 North 15<sup>th</sup> Avenue, Suite 140, Phoenix, AZ 85007 or may bring an action in Tax Court (125 West Washington, Phoenix, Arizona 85003) within sixty (60) days of the receipt of this order. For appeal forms and other information from the Board of Tax Appeals, call (602) 364-1102. For information from the Tax Court, call (602) 506-3763.

Dated this 26th day of July 2010.

ARIZONA DEPARTMENT OF REVENUE

Gale Garriott  
Director

Certified original of the foregoing  
mailed to:

[redacted]

cc: Transaction Privilege and Use Tax Section  
Office of Administrative Hearings  
Transaction Privilege Tax Appeals