

NOTICE

July 12, 1999

RE: PRIVATE TAXPAYER RULING LR96-011

Pursuant to Arizona Revised Statutes (A.R.S.) § 42-2101(B), the Department of Revenue is hereby giving notice of modification of private taxpayer ruling LR96-011, issued December 5, 1996.

For purposes of the "Headworks" activity cited in the private taxpayer ruling, the 5'-0" water conduit and 54" influent piping do not qualify for exemption under A.R.S. § 42-5061.B.6 as pipes and valves four inches in diameter or larger used to transport oil, natural gas, artificial gas, water or coal slurry if used to transport sewage effluent. The remainder of the private taxpayer ruling remains in effect.

While the previous determination that the 5'-0" water conduit and 54" influent piping used for transporting sewage effluent qualified for exemption under A.R.S. § 42-5061.B.6 as pipes and valves four inches in diameter or larger used to transport oil, natural gas, artificial gas, water or coal slurry is valid from the date of issuance of the private taxpayer ruling (December 5, 1996) until the present, any future purchases of pipes or valves used for transporting sewage are subject to tax as of the receipt of this modification.

PRIVATE TAXPAYER RULING LR96-011

December 5, 1996

The following private taxpayer ruling is provided in response to your letter dated September 9, 1996, with additional information provided in your letter dated October 30, 1996, in which you requested the department to rule regarding the taxable status of items that the ... will purchase as the agent for

The following is a restatement of the facts as presented in your letter.

Statement of Facts:

The ... Company (...) has entered into an agency agreement with ... under which ... will purchase certain items that are used directly in processing. These items will be incorporated

into a project at the

THE AGENCY AGREEMENT

The Agency Agreement under which these items are to be purchased designates ... as purchasing agent and provides as follows:

In compliance with the laws of the State of Arizona regarding Sales and Use Taxes as applicable to the sale and installation of exempt machinery, equipment, and pipelines, the Contractor is hereby designated as the Agent for the Owner, and is authorized to purchase qualifying items on behalf of the Owner.

This designation as Agent for the Owner is limited and applies only to those purchases that properly qualify for exemption by becoming an integral part of those systems that together constitute the entire primary processing operation from the initial stage of where actual processing begins through the completion of the final end product(s), or as may otherwise qualify for exemption under such laws.

The criteria to be used by the Contractor for items qualifying for exemption may be found in the State of Arizona's Official Compilation of Administrative Rules and Regulations. Specific reference is made (but not limited) to R15-5-608, R15-5-1822, and R15-5-2321 of those rules and regulations.

This designation should not be construed to change or eliminate any other deductions or exemptions the Contractor would otherwise be entitled to, nor shall the Contractor's responsibility as stated in Section 305.3 of the Contract General Conditions (Permits, Laws, Taxes and Regulations) be altered.

Any taxes, penalties or interest assessed for improper or erroneous exemptions claimed under this designation as Agent for the Owner shall be shared equally by the Contractor and the Owner.

At the current time the ... Company does not have contracts with subcontractors to assist in the installation of items that are the subject of this ruling.

THE EXEMPT MACHINERY AND EQUIPMENT AND PIPES AND VALVES FOUR INCHES OR LARGER IN DIAMETER

Each of the following paragraphs lists the construction activity, the plant process associated with that activity, and the items which will be used in the activity.

1. Headworks:

Work to be completed is the modification and addition of a new parshall flume for measuring the flow of water to the new clarifiers, the installation of new weirs and weir wall to maintain hydraulic flows, the installation of new 5'-0" water conduit to divert the water flow to the new 54" influent piping and clarifiers.

Sewage is screened to remove coarse impurities. Heavy objects, such as nails, bolts, sand and gravel settle out at this stage in the process. The sewage is then diverted to the primary channels through the parshall flume into the influent piping to the Primary Clarifiers.

Items purchased include 5'-0" water conduit, 54" influent piping, weirs angle, weirs, grating and handrails. The weir wall is installed in the influent channel coming into the plant. This wall diverts the flow of the water that has been degrittled to the primary clarifiers. The weirs and weir angles are steel plates with 6" V-notches which are installed on the weir wall to control the influent flows (GPM) to enter into the primary clarifiers. The grating and handrails are installed to allow access to obscure flows, and remove debris that could get into the system.

2. Primary Clarifiers 1 through 6, 9 and 10:

The work includes installation of new clarifier tanks #9 and #10, new clarifier mechanisms, influent and effluent piping, sludge, scum and dewatering lines, construction of new Pump Station #14 with associated pumps and piping to distribute clarified products.

Lighter suspended solids settle out in the primary clarifiers and are pumped through pump stations to the gravity thickeners. In the tanks the clarifier mechanism scrapes the sludge from the bottom of the tanks and skims the scum from the surface over the weirs. The clarified solution is then decanted over weirs and proceeds through the treatment process. The scum pumps, sludge pump and dewatering pump at Pump Station #14 remove scum, sludge and water through 4", 8", 10" and 12" piping systems. The work also includes modification in the primary clarifiers 1 through 6 with installation of piping, valves, new weirs, baffles, electrical, and instrumentation, which has the same type of equipment and piping for processing sludge, scum and water.

Items purchased will include holding tanks, piping, valves, clarifier mechanism, handrail, pumps, weirs, grating and frames, motor control center, paint, pipe insulation, waterproofing, waterstop, hatches, weir gates, plumbing, electrical, instrumentation, fiberglass weirs, baffles. The waterstop is a rubber seal between the base of the clarifier tank and the wall tank that keeps the tank from leaking and is an integral part of the tank. The handrail frame and grates provide access to the center of the tank to observe processing and adjust equipment (clarifier mechanism) to maintain the proper processing. The primary clarifiers are driven by electrical power which is controlled by motor control centers. These motor controls divert and control the

electrical source for all the individual electrical items requiring power for the processing. The electrical instrumentation consists of flow indicators mounted on the influent channels to control the correct water flows for proper processing. The baffles are 1/4" x 12" steel plates that are installed in the clarifiers at the influent channels to remove scum which accumulates on top of the water during the processing. This scum is removed through the pump stations. The epoxy paint and water proofing are an integral part of the process equipment and is applied to protect the submerged portions of the equipment.

3. Pump Station #4:

The work to be completed is the installation of new gas drive pump engines. These engines drive pumps that circulate the clarified solution through the biofilters or aeration basins.

Items to be purchased include engines, piping valves, instrumentation, electrical, paint, silencers. The electrical control panels show the flow rates, temperatures, and other information regarding the processed water. The electrical instrumentation starts and stops the engine driven pumps to move the flows of the processed water being pumped to the aeration basins or biofilters.

4. Aeration Basins / Biofilters /Blower Building:

The work in this area includes installation of new aerators, new topping for existing Aeration Basins, Biofilter influent structure and new 66" Biofilter channel, piping, modifications to existing Blower Building, installation of new gas engines, blowers.

Clarified solution from the primary clarifiers flows to biofilters in warm weather or to aeration basins during cold weather. The biofilters are approximately 150 foot diameter by 36 foot tall above ground concrete vessels in which "clarified" solution is trickled through a filter media. During colder months, the solution is processed through the aeration basins to increase the oxygen content of the solution in order to aid bacteria in the decomposition of organic material within the solution. The aeration basins are a 214 foot by 118 foot by 17 foot deep underground tank divided into separate basins by divider walls. On the bottom of this treatment station are diffusers which force air into the solution. The air supply for the diffusers is produced by blowers located in the blower building.

Items purchased include aerators, piping, valves, weirs, topping, blowers, engines, louvers, paint. Topping is a slurry coating applied to the bottom of aeration tanks to prevent leakage. The louvers control intake air into the blowers. The engine driven blowers provide air to the aeration basins so the process water does not become stagnate during processing.

5. Secondary Clarifier:

No work is scheduled.

6. Gravity Thickeners (primary and waste):

The construction and modifications in this area include modifications to Gravity Thickeners #1, and #2, construct new Gravity Thickener #3, metering building, chemical storage building, and odor control system.

The sludge which was removed at the primary clarifiers is pumped to the thickener vessels and then distributed to the digesters. The thickeners process the sludge by decanting the remaining water with a weir system and the mechanical clarifying equipment in the tank removes the solids by scraping the bottom and transferring the sludge material through the meter building piping system to various digesters. These thickeners take the sludge and water mixture which is removed at the primary clarifiers and continue the dewatering of the sludge and scum.

Items to be purchased include holding tank, water stop, water proofing, plumbing, paint, insulation, gravity thickener mechanism, FRP duct, dome cover, piping, valves, electrical, instrumentation, pumps. The holding tanks contain the liquid and mechanical rake arm to clarify the solution, the FRP weirs control the water flow. The tank is like the primary clarifiers including the water stop, electrical and instrumentation. The piping and pumps remove the sludge to digesters and the process water to the secondary clarifiers for more processing. The paint is part of the mechanical equipment as it protects the steel rake arms that are in a submerged environment. The FRP duct and HVAC maintain the proper temperature in the gravity thickener for processing.

7. Digester Gas Reuse System:

The work that will be done includes the installation of a new digester gas reuse system and modification of existing Control House #4 and Pump Station #7.

Sludge from the gravity thickeners is separated and sent to Digester where the solids are broken down by bacterial action which produces methane gas. This gas is then cleaned, compressed, and cooled, then distributed to the mechanical building to provide fuel for the engine drive electrical generators for powering pumps, motors, etc. Also, the gas is piped to the gas engines at P. S. #4 (these pump engines and blower engines are discussed in items 3 and 4). The sludge from the gravity thickener is pumped to the digesters where the solids are broken down by bacterial action to produce methane gas. The methane gas compressors compress the methane gas that is piped to the gas engines pumps in Pump station #4, the primary distribution pumps for the plant process water distribution system. The digest gas system provides gas to other pumps throughout the system and to smaller pumps.

Items to be purchased include pumps, piping, valves, instrumentation, paint, equipment pads, compressors, heat exchangers, roof sleeves, flow meters, electrical, and chillers. The items that are being claimed as exempt are the gas compressor, piping, instrumentation, and electrical motor control systems associated with this process. The instrumentation includes flowmeters that monitor the supply of gas being distributed for use, also pressure indicator and temperature probes monitor electronically temperatures and pressures in the system. The motor control centers electronically control the flows and distribution of the gas systems.

8. Dechlorination and Chlorination Facilities:

The work to be performed includes the installation of chlorination equipment in the existing chlorination facilities and installation of new dechlorination equipment at the new dechlorination facilities.

The dechlorination and chlorination facilities are the last step in the water process. The clarified solution from the secondary clarifiers is discharged into existing chlorine contact basins. Chlorine is injected to kill the bacteria in the processed water, and sulfur dioxide is then injected to neutralize the chlorine to finalize the processing of the effluent water which is then discharged from the plant and used for farm irrigation or the irrigation of parks and golf courses.

Items to be purchased include containment tanks, handrails, stairs, grating, and platforms for access to the operating valves, chlorination and dechlorination equipment, chemical tanks, piping, valves, instrumentation, flowmeters, paint, electrical, louvers, and ventilation equipment, pumps, FRP ductwork, generators. The items which are to be claimed as exempt are the chemical holding tanks, the injection system, instrumentation, electrical motor control centers, and associated piping. The holding tanks contain the chlorine and sulfur dioxide that are injected into the water to kill any bacteria and neutralization of the chlorine as discussed above. The instrumentation includes flowmeter, probes, pressure indicators to monitor the quantities of chlorine and sulfur dioxide injected into the process water. The motor control centers control the electrical systems. The grating, handrail and stairs provide access to tanks, valves and other items for operation and maintenance. The paint is integral to the processing equipment. The FRP duct is for removal of all chlorine or sulfur dioxide which may escape during the processing.

Your Position:

After reviewing the Revised Arizona Statutes, it is your interpretation that the materials and equipment listed above are tax exempt if purchased pursuant to a valid agency agreement with the owner of the water treatment plant. In addition, purchases of exempt machinery and equipment by subcontractors performing work for ... under this contract would also be exempt from transaction privilege tax.

Applicable Statutory Provisions:

Arizona Revised Statutes (A.R.S.) § 42-1310.01 levies the transaction privilege tax on the business of selling tangible personal property at retail. "Selling at retail" is defined as a sale for any purpose other than for resale. All retail sales are subject to tax unless specifically exempted by statute.

A.R.S. § 42-1310.01.B.1 exempts from the retail classification sales of machinery and equipment used directly in manufacturing or processing.

A.R.S. § 42-1310.01.B.6 exempts from the retail classification sales of pipes or valves four inches in diameter or larger used to transport oil, natural gas, artificial gas, water or coal slurry.

Arizona Administrative Code (A.A.C.) rule R15-5-120 defines the term "machinery and equipment used in processing" as including machinery or equipment that constitutes the entire primary manufacturing or processing operation from the initial state of where actual processing begins through the completion of the finished end product. The rule defines "manufacturing" as the performance of an integrated series of operations that place tangible personal property in a form, composition, or character different from that which it was acquired and transforms it into a different product with a distinctive name, character or use.

Arizona Administrative Code (A.A.C.) rule R15-5-608.C provides that when a contract between a builder and an owner contains an agency agreement authorizing the builder to purchase exempt machinery and equipment for the account of the owner, the cost of such equipment is not deemed to be contracting income, even though it is installed by the builder.

Discussion:

A.R.S. § 42-1310.01.B.1 provides transaction privilege tax exemptions for machinery and equipment used directly in manufacturing or processing. The term "used directly" includes machinery and equipment utilized during the period between the beginning and end of the actual exempt activity and includes those items which are essential to the operation and make it an integrated system. *Duval Sierrita Corporation v. Arizona Department of Revenue*, 116 Ariz. 200, 204, 568 P.2d 1098 (App. 1977).

A.R.S. § 42-1310.01.B.6 provides an exemption from transaction privilege tax for sales of pipes or valves four inches in diameter or larger used to transport oil, natural gas, artificial gas, water or coal slurry.

These exemptions are limited to sales of tangible personal property by a retailer. While the items that make up the wastewater treatment plant, such as cement and lumber, are personal property prior to being incorporated into the structure, tangible personal property loses its

personal property characteristics by incorporation into a completed structure and it becomes as much real property as the land itself. Through the application of a contractor's skill and labor, materials employed in the completed job can no longer be distinguished as personalty. See *Duham v. State Tax Commission*, 65 Ariz. 268, 179 P.2d 259 (1947).

A wastewater processing facility is real property and construction work performed at the facility is subject to transaction privilege tax under the prime contracting classification. A.R.S. § 42-1310.16 levies the transaction privilege tax on the business of prime contracting. Prime contracting includes altering, repairing, adding to or subtracting from real property. The tax base for the prime contracting classification is sixty-five per cent of the gross proceeds of sales or gross income derived from the business.

Currently, there are no statutory provisions under the prime contracting classification that exempt the income from construction contracts with manufacturers or processors from the transaction privilege (sales) tax. Therefore, the income from construction contracts with such persons is subject to tax.

However, tangible personal property consisting of machinery and equipment used directly in manufacturing or processing and pipes and valves four inches in diameter and larger may be deducted from a prime contractor's tax base if an agency relationship is established between the contractor and the manufacturer or processor. Once the agency relationship is contractually established, the exempt or taxable status of materials purchased on behalf of the principal under the agency agreement is determined by the retail transaction privilege tax provisions.

For purposes of the exclusion provided in A.A.C. R15-5-608.C, an agency relationship must be manifested by written agreement between the processor and builder which is incorporated in or appended to their construction agreement. The agreement must vest in the agent the authority to make purchases on behalf of the principal (i.e., to bind the principal) and must reserve to the principal the right to control or direct the manner by which such purchases are made. These essential elements must be substantiated by conduct of the parties consistent with the agreement.

An agency relationship is a contractual relationship between two persons, under which one party (the agent) acts for and on behalf of the other party (the principal) subject to the principal's control. It is a legal relationship which depends on the existence of certain required factual elements.

The basic element of an agency is that the agent has the power to act on behalf of the principal with third persons and has the power to bind the principal. Another essential element in establishing an agency relationship is the right of the principal to control the actions of the agent.

A valid agency agreement appointing a contractor as special purchasing agent for the owner basically provides as follows:

1. Purchases are to be made by contractor in the name of owner as purchasing agent.
2. Title to material procured by contractor is to pass from the vendors directly to owner.
3. Payment for purchases is to be made from accounts maintained by contractor.
4. Invoices and billings are to be reviewed by contractor and are also subject to review by owner.

In addition to the agency agreement between contractor and owner, contractor may enter into an agreement with each subcontractor. The agreement will be between contractor, as purchasing agent, and the subcontractor and will specify a gross amount to be paid to the subcontractor for the material listed.

Under this agency structure, a subcontractor will not act as a purchasing agent under the agency agreement, but will be treated as a retailer of the building materials it is obligated to furnish and install under the subcontract agreement.

If a prime contractor's contract with manufacturer or processor includes an agency agreement, the cost of the building materials purchased by the prime contractor, as the purchasing agent for the organization, will not be deemed contracting income to the prime contractor.

The amount the contractor receives as reimbursement for the exempt purchases is excludable from the prime contractor's gross contracting revenue before computing its tax liability for the project. Therefore, the gross proceeds of sales or gross income which is reported on the monthly sales tax report (Form TPT-1) should not include the amount of the proceeds which is attributable to the exempt purchases.

Conclusion and Ruling:

The following rulings are given based on the facts presented in your request.

THE AGENCY AGREEMENT

The department rules that in order to purchase tangible personal property tax free under the exemption for machinery and equipment used directly in manufacturing or processing provided

by A.R.S. § 42-1310.01.B.1 and the exemption for pipes and valves four inches in diameter or larger used to transport oil, natural gas, artificial gas, water or coal slurry provided by A.R.S. § 42-1310.01.B.6, a contractor must have a valid agency agreement with the manufacturer or processor.

The department rules that the agreement termed "Contract Change Order Number 5" is not sufficient to establish an agency relationship enabling ... to purchase tangible personal property tax free under the manufacturing or processing exemption provided by A.R.S. § 42-1310.01.B.1 and the exemption for pipes and valves four inches in diameter or larger used to transport oil, natural gas, artificial gas, water or coal slurry provided by A.R.S. § 42-1310.01.B.6.

A valid agency agreement must provide that purchases are to be made in the name of the manufacturer or processor, with the manufacturer or processor's funds. Title to the items purchased must pass to the manufacturer or processor at the time of purchase.

THE EXEMPT MACHINERY AND EQUIPMENT AND PIPES AND VALVES FOUR INCHES OR LARGER IN DIAMETER

The department rules that if a valid agency relationship is established between ... and the ..., ... could deduct the cost of the following machinery and equipment that will be used directly in processing and pipes or valves four inches or more in diameter from its tax base:

1. Headworks:

5'-0" water conduit and 54" influent piping would qualify for exemption under A.R.S. § 42-1310.01.B.6 as pipes and valves four inches in diameter or larger used to transport oil, natural gas, artificial gas, water or coal slurry.

Weirs and weir angles are installed on the weir wall to control the influent flows. They would qualify for the exemption under A.R.S. § 42-1310.01.B.1 for machinery and equipment that is used directly in manufacturing or processing.

2. Primary Clarifiers 1 through 6, 9 and 10:

The holding tanks, clarifier mechanism, pumps, paint used on exempt machinery and equipment, pipe insulation used on pipes that are exempt from tax, waterproofing on exempt machinery and equipment, waterstop, weir gates, instrumentation that is a component part of exempt machinery and equipment, fiberglass weirs, and baffles are used in the processing of wastewater. Therefore, they would qualify for the exemption under A.R.S. § 42-1310.01.B.1 for machinery and equipment that is used directly in manufacturing or processing.

3. Pump Station #4:

The clarified solution is circulated through the piping and valves. The engines drive the pumps that circulate the clarified solution through the biofilters or aeration basins. These items would qualify for the exemption under A.R.S. § 42-1310.01.B.1 for machinery and equipment that is used directly in manufacturing or processing.

4. Aeration Basins/Biofilters/Blower Building:

The aerators, piping, valves, weirs, blowers, engines, and louvers are used directly in the wastewater treatment process. These items would qualify for the exemption under A.R.S. § 42-1310.01.B.1 for machinery and equipment that is used directly in manufacturing or processing.

5. Secondary Clarifier

None.

6. Gravity Thickeners (primary and waste):

The waterstop, water proofing used on exempt machinery and equipment, plumbing, insulation used on pipes that are exempt from tax, gravity thickener mechanism, dome cover, piping, valves, electrical that is a component part of exempt machinery or equipment, instrumentation that is a component part of exempt machinery or equipment, and the pumps are used in the process by taking the sludge and water mixture and continuing the process. These items would qualify for the exemption under A.R.S. § 42-1310.01.B.1 for machinery and equipment that is used directly in manufacturing or processing.

7. Digester Gas Reuse System:

The pumps, piping, valves, instrumentation that is a component part of exempt machinery or equipment, compressors, heat exchangers, flow meters, electrical motor controls that are a component part of exempt machinery or equipment and chillers are used directly in the processing of sludge into methane gas. These items would qualify for the exemption under A.R.S. § 42-1310.01.B.1 for machinery and equipment that is used directly in manufacturing or processing.

8. Dechlorination and Chlorination Facilities:

The chlorination and dechlorination equipment, piping, valves, instrumentation that is a component part of exempt machinery or equipment, flow meters and electrical controls that are a component part of exempt machinery or equipment, louvers, and pumps are used directly in the final step in the process. These items would qualify for the exemption under A.R.S. § 42-

1310.01.B.1 for machinery and equipment that is used directly in manufacturing or processing.

TAXABLE MACHINERY AND EQUIPMENT

The department further rules that the cost of the following items shall be included in the tax base under the prime contracting classification:

1. Headworks:

The grating and handrails are used to allow access to this area of the plant and not used directly in the processing operation.

2. Primary Clarifiers 1 through 6, 9 and 10:

The handrails, grating and frames, paint that is used on the structure rather than on exempt machinery or equipment, waterproofing that is used on the structure rather than on exempt machinery or equipment, the motor control center, and electrical and instrumentation that is incorporated into the real property, are not tangible personal property used directly in the processing operation.

3. Pump Station #4:

Paint that is used on the structure rather than on exempt machinery or equipment, the silencers, electrical and instrumentation that are incorporated into real property, are not tangible personal property used directly in the processing operation.

4. Aeration Basins/Biofilters/Blower Building:

Paint and topping that is used on the structure rather than on exempt machinery or equipment are not tangible personal property used directly in the processing operation.

5. Secondary clarifiers

None.

6. Gravity Thickeners (primary and waste):

Paint that is used on the structure rather than on exempt machinery or equipment, insulation, FRP duct, dome cover, and electrical and instrumentation that are incorporated into real property, are not tangible personal property used directly in the processing operation.

7. Digester Gas Reuse System:

The equipment pads, electrical that is incorporated into the real property, paint that is used on the structure and the roof sleeves are not tangible personal property used directly in the processing operation.

8. Dechlorination and Chlorination Facilities:

The containment tanks, handrails, stairs, grating, and platforms for accessing to the operating valves, paint, and electrical that is incorporated into real property, are not used directly in the processing operation. In addition, the chemical storage tanks, FRP ductwork and generators are not used directly in the process.

The conclusion in this private taxpayer ruling does not extend beyond the face of the submitted agreements. It is the responsibility of all parties involved in this transaction to maintain appropriate supporting documentation.

This response is a private taxpayer ruling and the determination herein is based solely on the facts provided in your request. The determination in this taxpayer ruling is the present position of the department and is valid for a period of four years from date of issuance except as set out herein. This determination is subject to change should the facts prove to be different on audit. If it is determined that undisclosed facts were substantial or material to the department's making of an accurate determination, this taxpayer ruling shall be null and void. Further, the determination is subject to future change depending on changes in statutes, administrative rules, case law or notification of a different department position.