

PRIVATE TAXPAYER RULING LR03-005

May 16, 2003

This private taxpayer ruling is in response to your letter of January 6, 2003. You requested the Department to rule on behalf of your client . . . (the "Company"), that certain machinery and equipment identified on a list provided with your letter that the Company will use in its mail order prescription services business are exempt from Arizona transaction privilege and use taxes.

The following is a redacted statement of the facts as presented in your letter:

A. Description of the Company

. . . .

The Company provides mail order prescription services for patients covered by the Company's clients. The Company has five processing plants The processing plant in [City] is located at [Address] (the "Old [City] Plant").

B. The [City] Plant

The Company is building a new plant in [City] (the "[City] Plant") which will replace the Old [City] Plant. The [City] Plant will be a state-of-the-art processing facility rivaling any prescription mail order processing facility in the world. The Old [City] Plant processes approximately 15,000 prescriptions per day using approximately 150 employees. The [City] Plant, on the other hand, will process between 60,000 to 90,000 prescriptions per day using approximately 400 employees. . . . This vast increase in production capability will be accomplished by a processing line of technically advanced robotics and other machinery and equipment that to a large extent eliminate the human component in filling prescriptions. . . .

. . . .

E. Methods of Acquiring Machinery and Equipment

The acquisition of the machinery and equipment to be used in the

[City] Plant will fall within three categories. The first category is machinery and equipment acquired by the Company directly from Arizona vendors, the second category is machinery and equipment acquired by the Company directly from out-of-state vendors, and the third category is machinery and equipment acquired by the Company through a prime contractor.

Your Position

The machinery and equipment used in specified areas of the [City] Plant's operations are exempt from Arizona transaction privilege and use taxes under the retail and use tax exemptions of Arizona Revised Statutes ("A.R.S.") §§ 42-5061(B)(1) and 42-5159(B)(1), or the prime contracting exemption provided under A.R.S. § 42-5075(B)(9).

Conclusion and Ruling

A private taxpayer ruling makes specific tax determinations, and pursuant to A.R.S. § 42-2101 (A), the Department will only issue one when it affects the taxpayer or potential taxpayer requesting the ruling. Arizona transaction privilege tax is imposed on vendors, not purchasers; the Company is not a vendor of the machinery and equipment at issue. Consequently, this private taxpayer ruling addresses only the use tax consequences in purchases of machinery and equipment by the Company.

Based on the information provided, the Company's business operation for the dispensing and sale of prescription drugs to the consumer market does not constitute processing pursuant to A.R.S. § 42-5159(B)(1). To qualify for the exemption, the Arizona Court of Appeals holds that a business must be "commonly understood" to be a manufacturing or processing operation, and not merely one "in the abstract, or in isolation." See Ariz. Dep't of Revenue v. Blue Line Distrib., Inc., 43 P.3d 214, 216 (2002). While Company employs innovative or sophisticated machinery and equipment in its operation, its activities are virtually indistinguishable from those of a traditional pharmacy. A pharmacy is not commonly understood to be a manufacturing or processing operation.

Additionally, Company's operation is not the primary manufacturing or processing operation performed on the prescription drugs, thus removing it from the scope of the exemption. Arizona Administrative Code ("A.A.C.") R15-5-2320(A) states that "[m]achinery or equipment used in manufacturing or processing includes machinery or equipment that constitutes the entire *primary* manufacturing or processing operation" (emphasis added). Whether it is manufacturing or processing, the primary or *initial* operation concludes at the end of the first integrated system of manufacturing or processing activities performed upon materials that

comprise a finished product. No subsequent manufacturing or processing on the product that does not act to change the form of the product or is not an integrated part of the initial system of manufacturing or processing activities is considered an activity in the primary manufacturing or processing operation.

In this case, a pharmaceutical uses raw materials to manufacture prescription drugs and packages the products in bulk containers for domestic sale to distributors authorized by federal and state law such as Company. Both the manufacturing and packaging operations of the pharmaceutical would fall within the scope of the exemption. Nevertheless, the primary operation ends when the pharmaceutical packages their products into bulk containers for the market of authorized distributors. Company then dispenses quantities of the purchased drugs to prescription order; it does not mass-package the drugs it purchases in uniform quantities into uniform containers and is distinguishable from the many commercial businesses that do.

The following ruling is given based on the facts presented in your request.

The Department rules that machinery and equipment used in the Company's mail order pharmacy operations are beyond the scope of the exemption provided by A.R.S. § 42-5159(B) (1) and are subject to Arizona use tax. The Company's business operation is analogous to that of a traditional pharmacy, which does not constitute processing as it is commonly understood. Furthermore, Company's operation is not the primary manufacturing or processing operation performed on the prescription drugs, which also removes it from the scope of the exemption.

The conclusion of this private taxpayer ruling does not extend beyond the facts presented in your January 6, 2003 letter.

This response is a private taxpayer ruling and the determination herein is based solely on the facts provided in your request. The determinations are 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.

The determinations in this private taxpayer ruling are only applicable to the taxpayer requesting the ruling and may not be relied upon, cited, nor introduced into evidence in any proceeding by a taxpayer other than the taxpayer who has received the private taxpayer ruling.