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PRIVATE TAXPAYER RULING LR04-008

October 21, 2004

This private taxpayer ruling is in response to your letter dated July 8, 2004, as updated on August 17, 2004 and September 7, 2004, in which you requested a private taxpayer ruling on behalf of your client, . . . (Taxpayer). You request a ruling concerning the applicability of the exemption in Arizona Revised Statutes (A.R.S.) § 42-5061(B)(1) from transaction privilege tax for the purchase of equipment Taxpayer uses to process waste demolition material into reusable and resalable construction material. There are twelve items of equipment for which you feel the exemption applies. Pursuant to A.R.S. § 42-2101, the Department may issue private taxpayer rulings to taxpayers and potential taxpayers on request.

Statement of Facts:

Your July 8, 2004 letter presents the facts relating to Taxpayer's business as follows:

The Taxpayer is an Arizona corporation that provides excavation services and construction materials to construction companies and municipalities. Two of the construction materials that the Taxpayer provides to its customers are recycled concrete and recycled asphalt roadbase material. The Taxpayer produces these recycled materials from waste products it acquires from companies engaged in demolition. The waste results from the demolition of such structures as bridges, streets, curbs, buildings, blockwalls, and sidewalks and would otherwise be disposed in landfills. The Taxpayer processes these waste products into recycled concrete and asphalt road base materials using a custom-built recycling machine that separates the various materials and converts the material into a usable form that meets the Maricopa Association of Government's Specification No. 702 for construction and road base materials.

The recycled products are sold and delivered by the Taxpayer to builders, construction contractors, and municipalities for backfilling and road base material and for use in other construction activities. Sales of these materials are subject to transaction privilege tax, and unless the purchaser provides a properly executed exemption certificate, the Taxpayer collects tax on the sale of the recycled products.

The Taxpayer is currently leasing the machinery it uses to process demolition waste into recycled concrete and asphalt. It plans to purchase the recycling machinery upon the termination of the current lease term.

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You further described the equipment in a September 7, 2004 letter to this office, by providing as follows:

Several different pieces of equipment are utilized in the recycling process at issue in the [T]axpayer's request. The [T]axpayer requests that the ruling address all of the equipment that makes up the processing operation. Specifically, these items include the following equipment, listed in the order each item is employed in the processing operation:

1. Hydraulic Breaker: The first unit of equipment employed in the recycling process is a hydraulic breaker mounted on a tractor. This item breaks large pieces of concrete and asphalt waste material into pieces small enough to move through the rest of the recycling process. The hydraulic breaker is also used to remove large pieces of steel rebar from the waste material.
2. Front Loader: The next unit of processing equipment is a front loader used to deposit the concrete and asphalt into a feeder leading to the next stage of the recycling process.
3. Feeder: The feeder delivers the concrete and asphalt into the next stage of the recycling process, which consists of the primary breaking down of the recycled material.
4. Primary Breaker: The next unit of processing equipment performs the bulk of the "breaking down" of the concrete and asphalt into pieces small enough to be marketable.
5. Conveyor: After the material undergoes the primary break down, a conveyor moves the material under an electro-magnet.
6. Electro-magnet: The electro-magnet removes any remaining steel and rebar, which is often incorporated into the waste material, from the concrete and asphalt being recycled into construction material.
7. Separator: The remaining material to be recycled is then conveyed to a vibrating screen that separates over-size pieces from those that are already small enough. Pieces that meet the desired size move to a conveyor belt toward the scaling equipment.
8. Rotor-breaker: The separator drops the oversize pieces into a rotor that breaks them into smaller pieces. Once the oversize material is broken down in the rotor, it is returned to the separator.

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9. Conveyor: Material of the desired marketable size is deposited by the separator onto a conveyor belt that transfers the fully processed material to the scale belt.
10. Scale Belt: The scale belt weighs the fully processed material before it is stacked for shipping. At the end of the scale belt, the product is transferred to a stacking conveyor.
11. Stacking conveyor: The stacking conveyor transfers the fully processed material out of the recycling process in loads stacked for resale.
12. Generator: In addition, the equipment used to operate the recycling process includes an 800 kilowatt generator, which provides electric power to the majority of the equipment used in the recycling process.

Issue:

Whether the purchase of equipment described by Taxpayer is exempt from transaction privilege tax under the retail classification per A.R.S. § 42-5061(B)(1)?

Your Position:

Taxpayer's position as stated in your letters of July 8, 2004 and September 7, 2004:

The machinery in question meets all three tests for exemption from retail sales tax. First, the machinery is commonly understood to be machinery. Second, it is directly used in a specified activity because it is essential and integral to the activity. Third, the activity in which the machinery is directly used constitutes processing because it converts material to a new form for use or sale. Furthermore, because the sale of the products of the processing activity to the end user are subject to transaction privilege tax, if retail sales tax were due on the purchase of the machinery in question, the Legislature's purpose for the exemption would be frustrated.

Each item of equipment described above is necessary for the processing activity of recycling concrete and asphalt waste material into marketable construction material. Each of these items is utilized in the integrated, synchronized system that makes up the Taxpayer's processing operation.

Conclusion and Ruling:

Based on the information provided, the purchase of eleven out of the twelve items of equipment or machinery are not subject to transaction privilege tax under the retail classification per the exemption found in A.R.S. § 42-5061(B)(1) for the sale of equipment

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or machinery directly used in a processing operation, as such a processing operation is “commonly understood within [its] ordinary meaning”.

Arizona Administrative Code (A.A.C.) R15-5-120 helps to interpret this exemption by providing that,

[m]achinery or equipment used in manufacturing or processing includes machinery or equipment that constitutes the entire primary manufacturing or processing operation from the initial stage where the actual processing begins through the completion of the finished end product, processing, finishing, or packaging of articles of commerce.

Under this rule, the following pieces of equipment fit within the exemption because they play a role in the processing operation “through the completion of the finished end product”: hydraulic breaker, front loader, feeder, primary breaker, conveyor under electro-magnet, electro-magnet, separator, rotor-breaker, conveyor to scale belt, scale belt, and 800 kilowatt generator. When the material reaches the stacking conveyor it has already been transformed into the finished end product and would not qualify for the exemption. The function of stacking the already marketable quantities of recycled material is not sufficiently finishing or completing a product to constitute use in a processing operation.

In interpreting the equivalent use tax exemption in A.R.S. § 42-5159(B)(1), the Arizona Supreme Court held that certain items not traditionally considered equipment or machinery may qualify as such depending upon their function and also reaffirmed the “ultimate function” test used to determine if an item of equipment is used directly in a processing operation. *State ex rel. Ariz. Dep’t of Revenue v. Capital Castings, Inc.*, 207 Ariz. 445, 88 P.3d 159 (2004); *Duval Sierrita Corp. v. Ariz. Dep’t of Revenue*, 116 Ariz. 200, 568 P.2d 1098 (App. 1977). The Department does not doubt that the twelve items of equipment are indeed equipment in light of the broad definition of equipment provided in *Capital Casting*. See 88 P.3d at 162. However, not all of these items are equipment directly used in a processing operation as such an operation is commonly understood.

The “ultimate function” test in *Duval Sierrita* provides the proper analysis to make in order to determine if an item is directly used in a processing operation for purposes of the exemption. See 116 Ariz. at 205-06, 568 P.2d at 1104-05. Under this test, “a court should examine the nature of an item and its role in the operations. Items essential or necessary to the completion of the finished product are more likely to be exempt.” *Capital Casting*, 88 P.3d at 165. If an item is already placed in service, the test requires one to look at the item’s role in “maintaining a harmonious ‘integrated synchronized system’”. *Id.* The Arizona Supreme Court goes on to interpret this test by stating,

The closer the nexus between the item at issue and the process of converting raw materials into finished products, the more likely the item will be exempt. As part of its analysis, the court should consider whether an item physically

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touches the raw materials or work in process, whether the item manipulates or affects the raw materials or work in process, or whether the item adds value to the raw materials or work in process as opposed to simply reducing costs or relating to post-production activities. *Capital Casting*, 88 P.3d at 165.

This test again places emphasis on equipment that helps to create the finished product, not post-production activities such as those performed by the stacking conveyer at issue here. Similarly, this item of equipment does not manipulate or even add value to the recycled material. The stacking conveyor does not play a prominent role in the intergraded synchronized system sufficient to invoke the exemption.

Unlike the stacking conveyor, the 800 kilowatt generator does meet the above tests. It is essential to the completion of the finished end product under the ultimate function test. *Duvall Sierrita*, 116 Ariz. at 205-06, 568 P.2d at 1104-05. It provides the necessary power that allows the other qualifying equipment to process and without it the product could not be transformed into marketable form.

Accordingly, the Department rules that:

- (1) The sale of the following items of equipment are exempt from transaction privilege tax per A.R.S. § 42-5061(B)(1) because they constitute equipment or machinery used directly in a processing operation: hydraulic breaker, front loader, feeder, primary breaker, conveyor under electro-magnet, electro-magnet, separator, rotor-breaker, conveyor to scale belt, scale belt and 800 kilowatt generator.
- (2) The sale of the stacking conveyor, although an item of equipment, is not equipment directly used in the processing operation because it fails the "ultimate function test" in that it does not manipulate or add value to the material and performs only post-production activities.

The conclusions in this private taxpayer ruling do not extend beyond the facts presented in your correspondence dated July 8, 2004, August 17, 2004 and September 7, 2004 respectively.

This response is a private taxpayer ruling and the determinations herein are 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.

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The determinations in this private taxpayer ruling are applicable only 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.

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