Janet Napolitano
Governor

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Director

PRIVATE TAXPAYER RULING LR06-001

January 24, 2006

This private taxpayer ruling is in response to your letter dated May 17, 2005, as supplemented by your letters dated June 22, July 7, July 26, and September 1, 2005 in which you requested a private taxpayer ruling on behalf of . . . ("Taxpayer"). Additional information was provided in e-mails from . . . dated November 2, 2005. Specifically, you requested, on behalf of Taxpayer, a private taxpayer ruling regarding Taxpayer's transaction privilege tax liability for leasing equipment to the City of . . . ("City") for the purification of potable drinking water and for providing maintenance on reverse osmosis equipment owned by the City. Pursuant to Arizona Revised Statutes ("A.R.S.") § 42-2101, the Department may issue private taxpayer rulings to taxpayers and potential taxpayers on request. In accordance with A.R.S. § 42-2101(G), the Department issues this private taxpayer ruling addressing Taxpayer's future transactions and tax liabilities accruing from the date the taxpayer receives this ruling, to provide guidance on prospective actions Taxpayer may choose to undertake in substantially similar transactions.

I. Statement of Facts

Below is a restatement of the significant facts as provided in your May 17th request:

> [Taxpayer] is in the business of leasing equipment to be used by Municipal Water Districts or by private corporations for the purification of potable drinking water. The company owns patents on certain of the systems' components. The equipment is assembled in Arizona. The company has three alternative methods of conducting its business: (1) leasing the equipment to the customer, who operates the equipment; (2) maintaining the equipment through a separate maintenance contract; and (3) operating the equipment for the customer.

Below is a restatement of the significant facts as provided in your July 7th letter:

> The equipment is an integral part of the City's extraction of and purification of ground water for drinking. It is attached to the well pumping/water flow system that extracts the ground water. Water is routed through a piping/valve system into our equipment. Ozone is introduced to oxidize biological material and dissolve metals in the water. Following that in the process, ferric chloride and polymers are introduced to adhere to particulate matter in the water and to coagulate out the impurities. After that process, the water is put through a microfiltration unit which has an ability to filter out all but the smallest particles in suspension. The final product, clean water, called permeate, is then blended with water that is processed through a reverse osmosis machine that is owned by the City, with the specific objective of reducing fluorides to a level

> of less than 2. Our equipment enables the City's well to meet safe drinking water standards.
>
> The [City] has designated an area within its well complex for the installation of our equipment. [Taxpayer] works with construction, assembly, and electrical contractors we employ to pour the slab, install the piping, incorporate the electrical equipment that is used to operate the valves and pumps, and test the operation of the equipment. All of these functions are employed by our company and are directed by a Senior Engineer we employ full time.
>
> . . .
>
> [Taxpayer] does not operate the equipment; the City does. We do, however, maintain the equipment. We also have a maintenance contract for the reverse osmosis equipment that is owned by the City on the property.

Below is a restatement of the significant facts as provided in your September 1st letter:

> The system takes as its input groundwater pumped from a well at . . . and converts it to potable water. The result of the process is a substantive change in the quality of the water – potability – which makes it different from its composition when introduced into the system from the groundwater well.
>
> The [City] entered into a contract with [Taxpayer] on June 2, 2005, (Contract # . . .) for [Taxpayer] to design a "turnkey" system for the removal/reduction of biologic organisms, arsenic, iron and other metals, and fluorides from well water at a well location designated by the City as Well . . . (The . . . system). "Turnkey" means that [Taxpayer] designs, constructs, and tests the . . . system, then turns it over to the City in full operating condition that meets the standards of the contract for the volume of water processed, and biologic, arsenic, ferric, and fluoride content removed from the well water.
>
> This system is being integrated with an existing "Reverse Osmosis" (RO) system owned by the City in place at this Well. The end product consists of a blending of treated water produced by each system to balance fluorides and arsenic levels to meet EPA drinking water standards scheduled to be in effect in January of 2006. This water is pumped into a holding tank owned by the City adjacent to the premises, which, in turn, represents a source of drinking water for the City.
>
> At the commencement of the contract, the City-owned RO system was located on a commercial trailer. Now, the . . . and RO systems are both located on a slab of reinforced concrete approximately 50 feet from the wellhead. This slab was constructed by and is owned by [Taxpayer]. All

treatment operations for both systems take place on this concrete slab. The ground under the slab is owned by the City.

Several pieces of equipment are utilized in the treatment of water in the . . . system. These pieces are integrated into a system through a series of pipes elevated approximately 3 feet above the slab. Major components of the system consist of two buildings housing the equipment and supplies for introducing chemicals into the system, pumps and a series of vessels/filters in which impurities are captured and removed from the system.

The City entered into the contract with [Taxpayer] because its existing RO unit processes only 800,000 gallons per day of the potential 1.5 million gallons generated from the well. The . . . system processes the remainder.

All equipment in the . . . system is owned by [Taxpayer] and is leased to [City] in accordance with the terms of the contract.

In summary, the . . . water treatment system consists of a continuous flow process that is integrated with the City's RO system, and blended into an end product that provides drinking water for the City.

The following equipment lists were provided by . . . on November 2, 2005 via e-mail:

Influent Flow Meter – Existing City of . . . instrument provides an influent flow rate. This influent flow rate is necessary to control the rate of chemical feed to the process. (This meter is located at the well head)[.][1]

Influent pH – This instrument provides the influent pH (pH is a measure of the acidity of the water) of the raw well water. The pH must be monitored as it must be in a certain range to deliver the drinking water to the City. pH is lowered in the process, so this influent pH measurement is critical to process control. (This meter is located right before the ozone injection – before the pipe split)[.]

Influent ORP – This instrument provides the influent ORP (ORP is the oxidation-reduction potential). The ORP readings are predictive of the arsenic state. Therefore this instrument provides data to set and regulate the ozone dose. (This meter is located between the pipe split and the large reactor tanks)[.]

Effluent ORP – This instrument provides the effluent ORP. Again this reading is predictive of the arsenic state and must be maintained above a certain level

[1] The Department is unable to address whether this item is exempt machinery or equipment under A.R.S. § 42-5061(B)(1) as it is neither owned nor leased by Taxpayer.

to ensure the process is working. (This is located right before the bag filters)[.]

Effluent pH – The permits require the pH to be within certain limits. This instrument ensures process compliance. (This is located at the discharge of the facility right before the silver effluent flow meter)[.]

Effluent Flow Meter – The effluent flow meter provides the amount of flow delivered to the City of . . . system. It is also used to monitor and adjust the process blend, ensuring process operation. (This is the silver meter located on the plant discharge, just off the slab to the west)[.]

Pressure monitors – There are four pressure monitors in the system. These pressure monitors provide a differential pressure across the equipment and bag filters. When the differential pressure increases to a certain point the bag filters must be changed and the equipment backwashed. (These are located upstream and downstream of the bag filters and the microfilters)[.]

Pressure gauges – There are over a dozen pressure gauges on the system which serve to provide information on how the process is working, how much energy is required to operate the system and provide critical safety information to the operators.

. . . [T]hese critical monitors are connected to the computer control system. If any of these monitors are taking readings that are outside normal operating conditions the system will shut down automatically. This prevents any discharge of untreated water to the drinking water system.

Influent piping - Conveys the well water to the process - 8 inch diameter.

Ozone Injection - Injects the ozone gas into the water[.]

Ferric Chloride Injection - Injects the ferric chloride into the process water[.]

Reactor Tanks - 8 foot diameter tanks providing contact time and settling for the process[.] (2 total)

Bag Filters - 12 total bag filters that remove the contaminate from the water[.]

Microfilters - (2 total) provide fine filtration to remove the smallest particulate[.]

Recycle pumps - (2 total) provides a recycle flow rate to facilitate contaminate removal through the bag filters, dose chemicals and operate the microfilters.

Ozone Feed Water Pump - Provides a pressurized water flow to feed the ozone into the process water.

Connection piping - Conveys water from equipment to equipment - 8 inch in diameter[.]

Effluent piping - Conveys treated water from the process to the City drinking water system - 8 inch in diameter.

Below is a restatement of a portion of Contract # . . . for Well . . . Capacity Increase, dated June 1 and June 2:

The following City requirements may not be a part of the Contractor's offer but are a requirement of the City and become a part of this contract:

A. Provide and lease to the City a turnkey solution which will increase the output of Well . . . to at least 1.5mgd of potable water. The increased output will be accomplished with less than a 2% drop in efficiency.

B. Provide at no additional cost to the City all engineering for the design and construction of the proposed project. All designs will be sealed by a professional Engineer licensed in the State of Arizona.

C. Provide at no additional cost to the City, all necessary permits to construct and operate the water treatment facility improvements.

D. Apply for and obtain the Approval to Construct permit issued by the . . . County Environmental Services Department. The City will reimburse the Contractor for the actual cost of the Approval to Construct permit. The reimbursement amount is estimated to be $6000.00. Upon receipt of proof of payment for the Approval to Construct permit, the City will reimburse the Contractor for the actual cost. No other construction, operating or maintenance costs are payable or reimbursable by the City except as otherwise indicated in this contract.

E. Provide for total operations and maintenance including chemicals for the first 90 days of operation after the system begins production at full capacity. At the end of this period the City will be responsible for day to day operations including chemicals.

F. Provide at no cost to the City, all required scheduled maintenance and equipment repairs during the term of the lease to insure the system meets the minimum performance standards.

G. Provide at no cost to the City, engineering staff during the construction and start up of the system as required by the City.

H. Provide at no cost to the City, any and all modifications to existing facilities, piping, or equipment and provide and modify if necessary any additional new equipment, modifications, or supplies, necessary to assure the treated water at [W]ell . . . will reach 1.5mgd.

I. Provide on site training and all manuals necessary to assure the City will be able to operate the equipment as designed.

Below is a restatement of the services as listed in Exhibit A to the signed "CONTRACT FOR SERVICES" entered into between Taxpayer and City and dated July 8, 2005:

> [Taxpayer] will provide the maintenance for the RO machine at [W]ell . . . for $2,850.00 (plus any applicable sales taxes) per month commencing April 1, 2005. Invoices will be issued on the 20th of the month with payment due on the 1st of the succeeding month.
>
> This amount includes changing of the RO pre-filters on a monthly basis, changing the anti-scalant and making the day to day adjustments that may be needed. Also included is the Clean in Place which is to be performed every 90 days and the total inspection of the machine which is performed every 30 days. In addition, we will remove the membranes once a year to visually inspect them.
>
> It will be the City's responsibility to provide the micron pre-filters and the anti-scalent.
>
> <u>Services</u>
>
> <u>Services Typically Performed During Regular Weekly Visit</u>
>
> - Observe system operational parameters (flow, conductivity, pH, pressure drops) and compare to specified values[.]
> - Meet with system operator for new issues, occurrences, questions since last visit, and review operating logs, quick training Q & A[.]
> - Inspect chemical feed pumps for optimal settings, dosages and excessive wear; adjust feed rates as necessary. Review chemical mixing tank and procedure for proper operation.
> - Recommend spare parts to be ordered.
> - Day-to-day operation and maintenance (data logs, repairs, filter change-out) remain the responsibility of plant personnel.

Services Performed During Quarterly Visit

- . . . Maintenance Management Schedule[.]
- CIP of Membrane System[.]
- Spare parts ordering (with city authorization)[.]
- Flow balancing: Adjusting the volumetric recovery of the RO to the specified recovery[.]
- Remedial training (spot training)[.]
- Supervision and assistance in membrane element changeout (if required)[.]
- Calibrate probes against standard[.]
- Calibrate conductivity probes against conductivity reference standard[.]
- Verify flow meter k-factor calibration using storage tank volume change over time[.]
- Verify pressure transmitters against local pressure gauges; calibrate as required[.]
- Inspect and reset pump/motor alignment if needed, check for excessive vibration lubricate and change oil. Mechanical seal changeout (if required)[.]
- Check system for leaks and repair leaks to the extent possible[.]

Compensation

Vendor shall be compensated as follows:

- Monthly rate of $2850.00 per month plus tax payable on the first of the following month.
- Micron pre-filters and anti-scalent will be an additional charge to the City if the City elects to have . . . provide the material.

II. Issues

1. Whether the abovementioned items are exempt under either A.R.S. § 42-5061(B)(1) or 42-5061(B)(6).

2. Whether the proceeds from the agreement between Taxpayer and City for all required scheduled maintenance and equipment repairs during the term of the lease, as well as on site training and manuals, as stated in Contract # . . . for Well . . . . Capacity Increase, are subject to transaction privilege tax. In addition, whether the proceeds from the “CONTRACT FOR SERVICES” entered into between

Taxpayer and City for the maintenance of the City's reverse osmosis system located at Well . . . are subject to transaction privilege tax. [2]

III. Taxpayer's Position

Below is a restatement of your position as provided in your July 7th letter:

> A.R.S. § 42-5071(B)(2) exempts "leases or rentals of tangible personal property which, if it had been purchased instead of leased or rented by the lessee, would have been exempt under . . . A.R.S. § 42-5062(B)" [sic, A.R.S. § 42-5061(B)]. A.R.S. § 42-5061(B)(1), in turn, states that "machinery or equipment used directly in manufacturing, processing, fabricating, job printing, refining or metallurgical operations is exempt["].
>
> A.A.C. R15-5-120 states: "machinery 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 actual processing begins through the completion of the finished end product, processing, finishing, or packaging of articles of commerce. Manufacturing is the performance as a business of an integrated series of operations which place tangible personal property in a form, composition, or character different from that in which it was acquired and transforms it into a different product with a distinctive name, character, or use."
>
> Water taken from the ground via wells owned by the City of . . . is unsuitable for drinking. The processing of this water to remove harmful biological material, particulates in suspension such as arsenic, and chemical compounds in solution consists of "an integrated series of operations which

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[2] A.R.S. § 42-5075(B)(7) exempts the gross proceeds of sales or gross income derived from a contract entered into for the installation, assembly, repair or maintenance of machinery or equipment that is exempt from tax under A.R.S. § 42-5061(B). However, charges for the installation of such machinery or equipment, if such machinery or equipment becomes a permanent attachment, are subject to transaction privilege tax under the prime contracting classification. Moreover, gross proceeds of sales or gross income derived from that portion of the contracting activity which consists of the modification to real property in order to facilitate the installation of such machinery or equipment is not exempt from tax. In the context of a private taxpayer ruling, the Department is unable to address whether the installation of the machinery or equipment described is exempt from tax pursuant to A.R.S. § 42-5075(B)(7). Such determination requires a weighing of factors and variables that cannot adequately be resolved in the format of a private taxpayer ruling. The facts available to your business as well as the statute itself should give you guidance on whether or not some of the equipment described in your letter qualifies for the A.R.S. § 42-5075(B)(7) exemption. However, whether the installation of items that fall outside the A.R.S. § 42-5061(B)(1) exemption (such as the building housing such equipment or concrete slab on which such equipment is situated) is deemed contracting does not depend on whether such items are permanently attached. As the Arizona Court of Appeals has stated, "permanently attaching goods to real property for compensation may be sufficient to constitute contracting, but it is not the sine qua non of contracting." Brink Electric Construction Company v. Arizona Department of Revenue, 184 Ariz. 354, 361, 909 P.2d 421, 428.

> place tangible personal property in a form, composition, or character different from that in which it was acquired, and transforms it into a different product . . . ."
>
> The income from leasing this equipment to the City of . . . , we contend, is exempt as defined by the A.R.S. statutes.

IV. Applicable Law

A.R.S. § 42-5008 levies a transaction privilege tax measured by the amount or volume of business transacted by persons on account of their business activities.

A.R.S. § 42-5071 imposes the transaction privilege tax under the personal property rental classification. The personal property rental classification is comprised of the business of leasing or renting tangible personal property for a consideration.

A.R.S. § 42-5071(B)(2) exempts "[l]eases or rentals of tangible personal property which, if it had been purchased instead of leased or rented by the lessee, would have been exempt under . . . Section 42-5061, subsection B."

A.R.S. § 42-5061(B)(1) excludes "[m]achinery, or equipment, used directly in manufacturing, processing, fabricating, job printing, refining or metallurgical operations" from Arizona transaction privilege tax under the retail classification. The terms "manufacturing," "processing," "fabricating," "job printing," "refining," and "metallurgical" refer to and include those operations commonly understood within their ordinary meaning.

A.R.S. § 42-5061(B)(6) excludes "[p]ipes or valves four inches in diameter or larger used to transport oil, natural gas, artificial gas, water or coal slurry, including compressor units, regulators, machinery and equipment, fittings, seals and any other part that is used in operating the pipes or valves."

A.R.S. § 42-5061(C)(6) states that the deductions provided by A.R.S. § 42-5061(B) do not include sales of "[s]hops, buildings, docks, depots and all other materials of whatever kind or character not specifically included as exempt."

Arizona Administrative Code ("A.A.C.") R15-5-120 states 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 actual processing begins through the completion of the finished end product, processing, finishing, or packaging of articles of commerce. Manufacturing is the performance as a business of an integrated series of operations which place tangible personal property in a form, composition, or character different from that in which it was acquired and transforms it into a different product with a distinctive name, character, or use."

A.R.S. § 42-5069 imposes the transaction privilege tax under the commercial lease classification. The commercial lease classification is comprised of the business of leasing for a consideration the use or occupancy of real property.

A.A.C. R15-5-1502(D) states that "[g]ross income from the rental of tangible personal property includes charges for installation, labor, insurance, maintenance, repairs, pick-up, delivery, assembly, set-up, personal property taxes, and penalty fees even if these charges are billed as separate items, unless a specific statutory exemption, exclusion, or deduction applies."

A.A.C. R15-5-104(C) provides that

> [s]ales of tangible personal property shall be considered inconsequential elements of the service if:
>
> 1. The purchase price of the tangible personal property to the person rendering the services represents less than 15% of the charge, billing, or statement rendered to the purchaser in connection with the transaction;
>
> 2. At the time of the sale, the tangible personal property transferred is not in a form which is subject to retail sale; and
>
> 3. The charge for the tangible personal property is not separately stated on the invoice.

Arizona Transaction Privilege Tax Ruling TPR 93-28 states that "gross proceeds of sales or gross income derived from the sale of warranty contracts and maintenance service contracts which provide for the performance of contracting services are subject to transaction privilege tax under the prime contracting classification." However, the "gross proceeds of sales or gross income derived from the sale of contracts which provide for the performance of nontaxable services is not subject to transaction privilege tax under the prime contracting classification."

Arizona General Tax Procedure GTP 01-3 provides that the Department ordinarily will not issue private taxpayer rulings where the question involves a fact-intensive issue.

A.R.S. § 42-5023 states that it is presumed that all gross proceeds of sales and gross income derived by a person from business activity classified under a taxable business classification comprise the tax base for the business until the contrary is established.

Duval Sierrita Corp. v. Ariz. Dep't of Revenue, 568 P.2d 1098 (Ariz. Ct. App. 1977). The boundaries of the exempt metallurgical or mining operation must be drawn taking into consideration the entire operation as it is "commonly understood" which operation must, of necessity, include those items which are essential to its operation and which make it an

integrated system. In addition, spare or replacement parts, as opposed to machinery or equipment already in service, are "used directly" in metallurgical or mining operations depending on such machinery or equipment's ultimate function in the mining or metallurgical processes.

State *ex rel.* Ariz. Dep't of Revenue v. Capitol Castings, Inc., 88 P.3d 159 (Ariz. 2004). The "integrated rule" and "ultimate function" tests outlined in Duval Sierrita were expressly adopted by the Arizona Supreme Court.

Ariz. Dep't of Revenue v. Blue Line Distrib., Inc., 43 P.3d 214 (Ariz. Ct. App. 2002). A restaurant that uses machinery or equipment to make pizza dough from scratch is not commonly understood to be either a "manufacturing operation" or a "processing operation."

State Tax Comm'n v. Holmes & Narver, Inc., 548 P.2d 1162 (Ariz. 1976). Where it can be readily ascertained without substantial difficulty which portion of a business is for non-taxable professional services (design and engineering), the amounts in relation to the company's total taxable Arizona business are not inconsequential, and those services cannot be said to be incidental to the contracting business, the professional services are not merged for tax purposes into the taxable contracting business and are not subject to taxation.

Brink Elec. Constr. Co. v. Ariz. Dep't of Revenue, 909 P.2d 421 (Ariz. Ct. App. 1995). Permanently attaching goods to real property for compensation may be sufficient to constitute contracting, but it is not the sine qua non of contracting.

V. Conclusion and Ruling

A. Are the above mentioned items exempt under either A.R.S. § 42-5061(B)(1) or 42-5061(B)(6)?[3]

A.R.S. § 42-5071 imposes the transaction privilege tax under the personal property rental classification. The personal property rental classification is comprised of the business of leasing or renting tangible personal property for a consideration. However, A.R.S. § 42-5071(B)(2) exempts "[l]eases or rentals of tangible personal property which, if it had

[3] A.R.S. § 42-5069 imposes Arizona's transaction privilege tax under the commercial lease classification. The commercial lease classification is comprised of the business of leasing for a consideration the use or occupancy of real property. A.R.S. § 42-5069(F)(2) defines "real property," for purposes of that section, as "any improvements, rights or interest in such property." In the context of a private taxpayer ruling, the Department is unable to address whether the installation of the machinery or equipment described is an improvement to real property. Such determination requires a weighing of factors and variables that cannot adequately be resolved in the format of a private taxpayer ruling. See Ariz. Dep't of Revenue v. Ariz. Outdoor Advertisers, Inc., 41 P.3d 631 (Ariz. Ct. App. 2002). However, if such installation is deemed an improvement to real property, the lease of such machinery or equipment would be subject to transaction privilege tax under the commercial lease classification and the exemptions provided by A.R.S. §§ 42-5071(B)(2), 42-5061(B)(1) and 42-5061(B)(6) would be inapplicable. The conclusions and rulings reached in this private taxpayer ruling apply to the extent that the items at issue remain tangible personal property after their installation.

been purchased instead of leased or rented by the lessee, would have been exempt under . . . Section 42-5061, subsection B." A.R.S. § 42-5061(B)(6), in turn, excludes "[p]ipes or valves four inches in diameter or larger used to transport . . . water . . . , including compressor units, regulators, machinery and equipment, fittings, seals and any other part that is used in operating the pipes or valves." Therefore, the influent and effluent piping, both of which are greater than four inches in diameter and transport water, are exempt from tax.

A.R.S. § 42-5061(B)(1) excludes "[m]achinery, or equipment, used directly in manufacturing, processing, fabricating, job printing, refining or metallurgical operations. The terms "manufacturing", "processing", "fabricating", "job printing", "refining" and "metallurgical" . . . refer to and include those operations commonly understood within their ordinary meaning."

Therefore, A.R.S. § 42-5061(B)(1), and in turn A.R.S. § 42-5071(B)(2), exempts (i) machinery or equipment (ii) used directly in manufacturing, processing, fabricating, job printing, refining or metallurgical operations, whereas (iii) the terms "manufacturing", "processing", "fabricating", "job printing", "refining" and "metallurgical" refer to and include those operations commonly understood within their ordinary meaning.

The Department determines that treating well water to make it suitable for drinking is processing as that term is commonly understood within its ordinary meaning.

The legislative intent in granting the tax exemption found in A.R.S. § 42-5061(B)(1) was to "encourage manufacturing businesses and investment in manufacturing equipment by exempting sales of such equipment." Ariz. Dep't of Revenue v. Blue Line Distrib., Inc., 43 P.3d 214, 216 (Ariz. Ct. App. 2002). The Arizona Supreme Court further stated that its interpretation of A.R.S. § 42-5159, the use tax equivalent of A.R.S. § 42-5061(B)(1), "should further, not frustrate, the policy of encouraging investment and spurring economic development." State *ex rel.* Ariz. Dep't of Revenue v. Capitol Castings, Inc., 88 P.3d 159, 162 (Ariz. 2004). Therefore, we must apply a broad, rather than narrow, definition of "machinery or equipment" that better serves the legislative goal of exempting machinery and equipment. We must apply "flexible and commonly used definitions of machinery and equipment within the relevant industry." Id. at 164.

Nevertheless, such items must also be used directly in manufacturing, processing, fabricating, job printing, refining or metallurgical operations. A.A.C. R15-5-120 states 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 actual processing begins through the completion of the finished end product, processing, finishing, or packaging of articles of commerce. Manufacturing is the performance as a business of an integrated series of operations which place tangible personal property in a form, composition, or character different from that in which it

> was acquired and transforms it into a different product with a distinctive name, character, or use.

Emphasis added. The language of A.A.C. R15-5-120 mirrors the language conveyed by the Arizona Court of Appeals in Duval Sierrita Corp. v. Arizona Department of Revenue, 568 P.2d 1098 (Ariz. Ct. App. 1977). Specifically, the court stated that

> [t]he boundaries of the exempt operation must be drawn taking into consideration the entire operation as it is "commonly understood" which operation must, of necessity, include those items which are essential to its operation and which make it an integrated system. We so interpret the words "used directly."

Id. at 1104 (emphasis added). Moreover, the Duval Sierrita court considered the question of whether spare or replacement parts, as opposed to machinery or equipment already in service, are "used directly" in metallurgical or mining operations. The court stated that "what the legislature intended by the use of the words "used directly" was to create a classification of personal property entitled to exemption from taxation, depending on its ultimate function in the mining or metallurgical processes." Id. at 1102-1103.

The "integrated rule" and "ultimate function" tests outlined in Duval Sierrita were expressly adopted by the Arizona Supreme Court in Capitol Castings. The Court stated the following:

> Items essential or necessary to the completion of the finished product are more likely to be exempt . . . . The prominence of an item's role in maintaining a harmonious "integrated synchronized system" with the indisputably exempt items will also directly correlate with the likelihood that the exemption applies . . . . 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 the item physically 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.

88 P.3d at 165. Having considered both the definition of "machinery or equipment" and the tests outlined above, the Department concludes that the following items are therefore both "machinery or equipment" and "used directly" in processing:

1. Ozone Injection
2. Ferric Chloride Injection
3. Reactor Tanks
4. Bag Filters
5. Microfilters

6. Recycle pumps
7. Ozone Feed Water Pump
8. Connection piping

The following monitors are similarly exempt machinery or equipment used directly in processing:

1. Influent pH
2. Influent ORP
3. Effluent ORP
4. Effluent pH
5. Effluent Flow Meter
6. Pressure monitors
7. Pressure gauges

These monitors are essential to the operation of the system and make it a synchronized integrated system. Each monitor is necessary to ensure that the process is working correctly at each stage. Therefore, each monitor is exempt from tax.

In addition, spare or replacement parts for the above machinery or equipment are likewise exempt as they meet the "ultimate function" test outlined above.

Whether a computer is "used directly" manufacturing or processing was addressed by the Court in <u>Capitol Castings</u>:

> [A] computer used in a business is "machinery" or "equipment." A computer used purely for administrative purposes, however, may not qualify for the exemption because it is not "used directly in manufacturing . . . operations." But if the computer is used to manage and control specific tasks conducted on an automated assembly line, the computer may well qualify for the exemption as it is "used directly in manufacturing . . . operations." Similarly, certain items not traditionally considered to be machinery or equipment may qualify as such depending on their function in the process.

88 P.3d at 164. The computer control system is not used for administrative purposes. Rather, it is used to receive data from the various monitors mentioned above. Should any of these monitors take readings that are outside the normal operating conditions, the system will shut down automatically, thereby preventing any discharge of untreated water to the drinking water system. The computer control system thus manages the automated system. It is "used directly" in the process and so, is exempt from tax.

However, the following items are not exempt from Arizona's transaction privilege tax:

1. The slab of reinforced concrete approximately 50 feet from the wellhead on which the equipment is situated, and

2. Two buildings housing the equipment.

A.R.S. § 42-5061(C)(6) states that the deductions provided by A.R.S. § 42-5061(B) do not include sales of "buildings . . . and all other materials of whatever kind or character not specifically included as exempt." Thus, the two buildings housing the equipment and the slab of concrete on which the equipment sits are not exempt.

A.R.S. § 42-5023 states that it is presumed that all gross proceeds of sales and gross income derived by a person from business activity classified under a taxable business classification comprise the tax base for the business until the contrary is established. To preserve any statutorily provided exemptions, exempt and non-exempt items should be separately stated in both the contract and books and records maintained in the regular course of business.

B. Are the proceeds from the agreement between Taxpayer and City for all required scheduled maintenance and equipment repairs during the term of the lease, as well as on site training and manuals, as stated in Contract # . . . for Well . . . Capacity Increase, subject to transaction privilege tax? In addition, are the proceeds from the "CONTRACT FOR SERVICES" entered into between Taxpayer and City for the maintenance of the City's reverse osmosis system located at Well . . . subject to transaction privilege tax?

A.A.C. R15-5-1502(D) states that "[g]ross income from the rental of tangible personal property includes charges for installation, labor, insurance, maintenance, repairs, pick-up, delivery, assembly, set-up, personal property taxes, and penalty fees even if these charges are billed as separate items, unless a specific statutory exemption, exclusion, or deduction applies." Therefore, gross income from the lease of the above mentioned machinery or equipment includes charges for all required scheduled maintenance and equipment repairs during the term of the lease, as well as on site training and manuals.

Nevertheless, the proceeds from the "CONTRACT FOR SERVICES" entered into between Taxpayer and City for the maintenance of the City's reverse osmosis system located at Well . . . may be exempt from transaction privilege tax. The Arizona Supreme Court has stated the following:

> Where it can be readily ascertained without substantial difficulty which portion of the business is for non-taxable professional services . . ., the amounts in relation to the company's total taxable Arizona business are not inconsequential, and those services cannot be said to be incidental to the . . . business, the professional services are not merged for tax purposes into the taxable . . . business and are not subject to taxation.

State Tax Comm'n v. Holmes & Narver, Inc., 548 P.2d 1162, 1166 (Ariz. 1976). If Taxpayer meets the above test, and therefore its maintenance services represent a

separate line of business, the proceeds from the "CONTRACT FOR SERVICES" entered into between Taxpayer and the City are not subject to tax.

In addition, A.R.S. § 42-5061(A)(1) exempts the gross proceeds of sales or gross income derived from "[p]rofessional or personal service occupations or businesses which involve sales or transfers of tangible personal property only as inconsequential elements." As stated above, the micron pre-filters and anti-scalent are generally not provided by Taxpayer. However, if the City elects to have Taxpayer provide such materials, there will be an additional charge for the same.

If the maintenance provided under the "CONTRACT FOR SERVICES" entered into between Taxpayer and City for the maintenance of the City's reverse osmosis system located at Well . . . is part of a separate line of business, then the sale of micron pre-filters and anti-scalent are subject to transaction privilege tax under the retail classification.

Finally, in the context of a private taxpayer ruling, the Department is unable to address whether either the installation of the machinery or equipment described above or the City's reverse osmosis system located at Well . . . is an improvement to real property. Such determination requires a weighing of factors and variables that cannot adequately be resolved in the format of a private taxpayer ruling. In addition, it is unclear whether the performance of required scheduled maintenance and equipment repairs during the term of the lease to insure that the system meets the minimum performance standards, as outlined in Contract # . . . for Well . . . Capacity Increase, dated June 1 and June 2, meets the definition of prime contracting.[4] It is also unclear whether the performance of required maintenance and equipment repairs under the "CONTRACT FOR SERVICES" entered into between Taxpayer and City to provide the maintenance for the RO machine at Well . . . meets the definition of prime contracting.

Arizona Transaction Privilege Tax Ruling TPR 93-28 states that "gross proceeds of sales or gross income derived from the sale of warranty contracts and maintenance service contracts which provide for the performance of contracting services are subject to transaction privilege tax under the prime contracting classification." However, the "gross proceeds of sales or gross income derived from the sale of contracts which provide for the performance of nontaxable services is not subject to transaction privilege tax under the prime contracting classification." Therefore, if the equipment at issue under either contract is deemed an improvement to real property, and if such maintenance or repairs under either contract meets the definition of prime contracting, charges for the same are subject to tax under the prime contracting classification.

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[4] A.R.S. § 42-5075(K)(5) defines "prime contracting" as "engaging in business as a prime contractor." A.R.S. § 42-5075(K)(6), in turn, defines a "prime contractor" as "a contractor who supervises, performs or coordinates the construction, alteration, repair, addition, subtraction, improvement, movement, wreckage or demolition of any building, highway, road, railroad, excavation, manufactured building or other structure, project, development or improvement including the contracting, if any, with any subcontractors or specialty contractors and who is responsible for the completion of the contract."

The conclusions in this private taxpayer ruling do not extend beyond the facts presented in your correspondence dated May 17, June 22, July 7, July 26, September 1, and November 2, 2005.

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.

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.

Lrulings/06-001-D