



PRIVATE TAXPAYER RULING LR11-004

Janice K. Brewer
Governor

Gale Garriott
Director

March 30, 2011

The Department issues this private taxpayer ruling in response to the ruling request on behalf of your client . . . ("Company") dated April 29, 2010, and the additional information and documentation provided with your letter dated August 13, 2010. You request the Department to rule as to the applicability of Arizona transaction privilege tax to your client's prime contracting activities to upgrade and expand a wastewater treatment plant . . . ("Project").

Specifically, you question whether the wastewater reclamation facility itself¹ and all machinery and equipment and related property at the plant qualify for exemption from transaction privilege tax under a statutory deduction related to pollution control. Alternatively, you question whether a deduction for machinery and equipment used in a processing operation, or a deduction for pipes or valves four inches in diameter or larger, apply to this project.

Statement of Facts:

The following facts are excerpted from your letter dated April 29, 2010:

Background of the . . . Project

The . . . County . . . has contracted with Company to execute the Project. This Project has been established and designed pursuant to objectives presented in the . . . Master Plan which was developed to allow . . . County to meet increased capacity needs and enhanced environmental regulatory requirements established by the Arizona Department of Environmental Quality (ADEQ) and the U.S. Environmental Protection Agency (EPA).

The original Facility . . . was designed to produce a treated effluent meeting secondary treatment quality requirements as set forth by ADEQ.

Regulatory objectives for effluent quality are established by each facility's permits. The Facility operates under an Arizona Pollution Discharge Elimination System (AZPDES) permit issued by ADEQ, which operates the AZPDES program under a delegation agreement with the U.S. EPA. The Facility also operates under a state-wide aquifer protection permit (APP) issued by ADEQ.

¹ With the exception of a few non-processing areas.

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The AZPDES permit for the Facility requires it to comply with enhanced ammonia removal standards by January 30, 2014. In January 2007, . . . County submitted a letter . . . to ADEQ describing its intention to meet the proposed permit requirements for removal of ammonia below toxic levels at the . . . Facility by 2014 as required by its permit.

. . . Project Execution

The Project is to be completed over the next [three] years and has been contracted under two contracts, awarded in Task-Orders under Guaranteed-Maximum-Price (GMP) work scope packages (Work Packages).

Issues:

- 1) Does the . . . Facility and all machinery, equipment and other tangible personal property used at the plant qualify for exemption from transaction privilege tax under a statutory deduction related to pollution control [Arizona Revised Statutes (A.R.S.) § 42-5061(B)(19)]?
- 2) What statutory deductions under the retail and prime contracting classifications apply to Taxpayer's income derived from the contract to upgrade and expand the . . . Facility?

Your Position

As stated in your private taxpayer ruling request dated April 29, 2010:

With the exception of certain non-process areas identified in Area D, Company . . . asserts that the entire Facility qualifies as pollution control machinery and equipment and related structural components as defined in A.R.S. § 42-5061(B)(19). Consequently, income attributable to Company's cost for Work Packages identified on the Work Package Plan (except for portions attributable to non-process areas in Area D) is exempt from Arizona transaction privilege tax. Additionally, or as an alternative position, certain components qualify as exempt machinery and equipment used directly in manufacturing or processing operations pursuant to A.R.S. § 42-5061(B)(1), or exempt pipes or valves four inches in diameter or larger used to transport water within the definitions of A.R.S. § 42-5061(B)(6).

As stated in your August 13, 2010 response to a request for additional information:

[T]he entire Facility qualifies as exempt pollution control equipment and related structural components. As stated in the enclosed ADEQ Discharge Elimination System Permit, . . . County is authorized to discharge treated wastewater and storm water from the Facility . . . to the . . . River.

[W]astewater and storm water from the . . . metropolitan area flows into the Facility, is treated to remove pathogens and debris, and is discharged into the . . .

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River “cleaned” where it will flow downstream to the next city. This processing of the wastewater and storm water is required by ADEQ pursuant to the various permits issued for the Facility in order to keep our water safe for use by citizens of our state.

Applicable Law / Authority:

A.R.S. § 42-5075 *Prime contracting classification*, imposes 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 percent of the gross proceeds of sales or gross income derived from the business. In pertinent part, A.R.S. § 42-5075(B)(9) provides the following deduction from the tax base of a prime contracting business:

The gross proceeds of sales or gross income attributable to the purchase of machinery, equipment or other tangible personal property that is exempt from or deductible from transaction privilege and use tax under:

...

(b) Section 42-5061, subsection B.

...

(d) Section 42-5159, subsection B.

A.R.S. § 42-5061 *Retail classification*, imposes the transaction privilege tax on income derived by persons engaged in the business of selling tangible personal property at retail, and provides deductions for income derived from certain retail sales, including the following sales of:

(B)(1) Machinery, or equipment, used directly in manufacturing, processing, fabricating, job printing, refining or metallurgical operations. The terms "manufacturing", "processing", "fabricating", "job printing", "refining" and "metallurgical" as used in this paragraph refer to and include those operations commonly understood within their ordinary meaning. "Metallurgical operations" includes leaching, milling, precipitating, smelting and refining.

(B)(6) Pipes 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.

(B)(19) Machinery or equipment, including related structural components, that is employed in connection with manufacturing, processing, fabricating, job printing, refining, mining, natural gas pipelines, metallurgical operations, telecommunications, producing or transmitting electricity or research and development and that is used directly to meet or exceed rules or regulations adopted by the federal energy regulatory commission, the United States environmental protection agency, the United States nuclear regulatory commission, the Arizona department of

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environmental quality or a political subdivision of this state to prevent, monitor, control or reduce land, water or air pollution.

A.R.S. § 42-5159 provides identical exemptions from the Arizona use tax under corresponding subsections.

Senate Bill 1245 (Laws 1999, First Regular Session, Chapter 87) added the phrase “including related structural components” after “[m]achinery and equipment” in the transaction privilege tax deduction provided by A.R.S. § 42-5061(B)(19) and the use tax exemption provided by A.R.S. § 42-5159(B)(19). All 1999 House Summaries and Senate Fact Sheets related to Senate Bill 1245 indicate that this was intended so as to include related tangible personal “property of a ‘structural nature’ that is attached to real property.” Senate Bill 1245 made no amendments to A.R.S. § 42-5075 *Prime contracting classification* related to the deduction provided by A.R.S. § 42-5061(B)(19).

Senate Bill 1245, Section 4, subsection H, provides session law addressing the amendments to A.R.S. § 42-5061(B)(19) and A.R.S. § 42-5159(B)(19):

The provisions of section 42-5061, subsection B, paragraph 19 and section 42-5159, subsection B, paragraph 19, Arizona Revised Statutes, as amended by this act, relating to structural components shall not be cited or considered in the construction or interpretation of any other exemption or deduction in section 42-5061 or 42-5159, Arizona Revised Statutes or any other section in chapters 5 and 6 of title 42, Arizona Revised Statutes.

(Emphasis added)

A.R.S. § 49-1202(13) provides the following definition for a wastewater treatment facility:

"Wastewater treatment facility" means a treatment works, as defined in section 212 of the clean water act, that is located in this state and that is designed to hold, cleanse or purify or to prevent the discharge of untreated or inadequately treated sewage or other polluted waters for purposes of complying with the clean water act.

Title 40, Code of Federal Regulations, Protection of the Environment, provides regulations for the Environmental Protection Agency's administration of the Clean Water Act, including regulations which provides standards and restrictions on the operation of a wastewater treatment plant under the auspices of a state program.

Discussion

Prime contracting classification:

Company's upgrade and expansion of the . . . Facility is a business activity that is subject to the transaction privilege tax imposed under the prime contracting

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classification. A.R.S. § 42-5075(B) describes the tax base for this classification as sixty-five percent of the gross income derived by a prime contracting business, but delineates certain amounts that may be deducted from gross income prior to the computation of the tax base.

A prime contractor does not sell tangible personal property. *Duhamé v. State Tax Comm'n*, 65 Ariz. 268, 179 P.2d 252 (1947). Exemptions under the retail classification do not apply under the prime contracting classification. *Brink Elec. Const. Co. v. Arizona Dept. of Revenue*, 184 Ariz. 354, 909 P.2d 421, (Ariz. App.1995). However, A.R.S. § 42-5075(B)(9) provides a deduction for income "attributable to the purchase of machinery, equipment or other tangible personal property that is exempt from or deductible from transaction privilege and use tax under . . . Section 42-5061, subsection B [and] . . . Section 42-5159, subsection B." (Emphasis added) Therefore, that portion of a prime contractor's income attributable to the retail purchase price of machinery and equipment and other tangible personal property that is exempt from tax under one or more subparagraphs contained in A.R.S. §§ 42-5061(B) or 42-5159(B), may be deducted from Company's gross income prior to the computation of Company's tax base under the prime contracting classification.

Retail classification:

Because A.R.S. § 42-5075(B)(9) provides a deduction for Company's purchase price of machinery, equipment or other tangible personal property that is exempt from transaction privilege tax or use tax under A.R.S. §§ 42-5061(B) or 42-5159(B), the following pertinent exemptions, as noted in your ruling request, may apply:

A.R.S. §§ 42-5061 and 42-5159, subsection (B)(6): Pipes 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.

Arizona Transaction Privilege Tax Ruling TPR 02-2 specifically addresses the applicability of the tax exemptions for pipes or valves, and is pertinent to Company's project.

A.R.S. §§ 42-5061 and 42-5159, subsection (B)(1): Machinery, or equipment, used directly in manufacturing, processing, fabricating, job printing, refining or metallurgical operations. The terms "manufacturing", "processing", "fabricating", "job printing", "refining" and "metallurgical" as used in this paragraph refer to and include those operations commonly understood within their ordinary meaning. "Metallurgical operations" includes leaching, milling, precipitating, smelting and refining.

A wastewater treatment plant is engaged in the *processing* of sewage and other wastewater to remove all pollutants and return reclaimed clean water to the

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environment. Therefore, income attributable to Company's purchase price of machinery and equipment used directly in the wastewater treatment plant's processing activity pursuant to A.R.S. § 42-5061(B)(1), may be deducted from Company's gross income under A.R.S. § 42-5075(B)(9).

A.R.S. §§ 42-5061 and 42-5159, subsection (B)(19): Machinery or equipment, including related structural components, that is employed in connection with manufacturing, processing, fabricating, job printing, refining, mining, natural gas pipelines, metallurgical operations, telecommunications, producing or transmitting electricity or research and development and that is used directly to meet or exceed rules or regulations adopted by the federal energy regulatory commission, the United States environmental protection agency, the United States nuclear regulatory commission, the Arizona department of environmental quality or a political subdivision of this state to prevent, monitor, control or reduce land, water or air pollution.

The primary issue raised in Company's private taxpayer ruling request, is the application of the transaction privilege tax deduction and use tax exemption respectively provided by A.R.S. §§ 42-5061(B)(19) and 42-5159(B)(19). The relevance of the A.R.S. § 42-5061(B)(19) deduction to the upgrade and expansion of a wastewater treatment plant is that it applies to the retail purchase of "[m]achinery or equipment, including related structural components, that is employed in connection with . . . processing . . . and that is used directly to meet or exceed rules or regulations adopted by . . . the United States environmental protection agency, . . . the Arizona department of environmental quality or a political subdivision of this state to prevent, monitor, control or reduce water or air pollution."

Regarding the 1999 addition of the phrase "including related structural components" to A.R.S. §§ 42-5061(B)(19) and 42-5159(B)(19) by Laws 1999, First Regular Session, Chapter 87, the legislative House Summaries and Senate Fact Sheets all provide that this was intended so as to include related *tangible personal* "property of a 'structural nature' that is attached to real property, but is treated as machinery for accounting purposes." (Emphasis added.) Based on the original version of Senate Bill 1245, this means that the structural components would be "capitalized and depreciated as machinery and equipment." The session law enacted by Senate Bill 1245 (Section 4, subsection H), states that the addition of the phrase "including related structural components" does not apply to any other exemption or deduction provided by A.R.S. §§ 42-5061 or 42-5159, and also does not apply to the "construction or interpretation of any other exemption or deduction in . . . any other section in chapters 5 and 6 of title 42, Arizona Revised Statutes."

Therefore, the addition of the phrase "including related structural components" to A.R.S. §§ 42-5061(B)(19) and 42-5159(B)(19) regarding retail sales, has no bearing on

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prime contracting activities and does not convey any exemption to prime contracting activities related to the construction or erection of structural components. The exemptions apply only to related structural components which may be purchased at retail.

Legislative history (Senate Fact Sheets and House Summaries) is often used by Arizona courts in interpreting statutory provisions and amendments. *See State ex rel. Arizona Dept. of Revenue v. Capitol Castings, Inc.*, 207 Ariz. 445, 88 P.3d 159 (Ariz. 2004); *Citadel Care Center v. Arizona Dept. of Revenue*, 200 Ariz. 286, 25 P.3d 1158 (Ariz. App. 2001); *Paging Network of Arizona, Inc. v. Arizona Dept. of Revenue*, 193 Ariz. 96, 970 P.2d 450 (Ariz. App. 1998); and *State ex rel. Arizona Dept. of Revenue v. Phoenix Lodge No. 708, Loyal Order of Moose, Inc.*, 187 Ariz. 242, 928 P.2d 666 (Ariz. App. 1996). The Department views the addition of “including related structural components” to the A.R.S. §§ 42-5061(B)(19) and 42-5159(B)(19) retail provisions as merely including the retail purchase of structural supports and components that are attached to real property for the machinery and equipment at issue, and are capitalized and depreciated as machinery and equipment for accounting purposes. The legislative history supports this interpretation.

Retail sales of machinery and equipment, including related structural components, for wastewater treatment plant machinery and equipment that is employed in connection with processing and that is used directly to meet or exceed rules or regulations adopted by the United States Environmental Protection Agency, the Arizona Department of Environmental Quality, or a political subdivision of this state to prevent, monitor, control or reduce water or air pollution, qualify for exemption from tax under A.R.S. §§ 42-5061(B)(19) or 42-5159(B)(19). Income attributable to Company’s purchase price of these qualifying items may be deducted from Company’s gross income under A.R.S. § 42-5075(B)(9).

Income derived from the *construction* of structural supports and components for such machinery and equipment by a prime contracting business does not qualify for exemption from tax under A.R.S. §§ 42-5061(B)(19) or 42-5159(B)(19), and therefore does not qualify for the deduction from the prime contractor’s gross income provided by A.R.S. § 42-5075(B)(9). The session law enacted by Senate Bill 1245 (Section 4, subsection H), confirms this position. Exemptions from taxation are to be narrowly construed against the taxpayer. *Ebasco Serv., Inc. v. Arizona State Tax Comm’n*, 105 Ariz. 94, 459 P.2d 719 (1969).

Conclusion and Ruling

Income derived from Company’s contract to upgrade and expand the . . . Facility is subject to transaction privilege tax under the prime contracting classification. A.R.S. § 42-5075(B)(9) allows the purchase price of machinery, equipment, and other tangible personal property that may be purchased at retail exempt from transaction privilege tax

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under A.R.S. § 42-5061(B) or exempt from use tax under A.R.S. § 42-5159(B), to be deducted from a prime contracting business's gross income prior to the computation of the tax base.

Company's purchases of machinery and equipment used directly in processing that are exempted from tax pursuant to A.R.S. §§ 42-5061(B)(1) or 42-5159(B)(1), may be deducted from its gross income under A.R.S. § 42-5075(B)(9). Company's purchases of pipes or valves and related equipment that are exempted from tax pursuant to A.R.S. §§ 42-5061(B)(6) or 42-5159(B)(6), may be deducted from its gross income under A.R.S. § 42-5075(B)(9).

The exemptions from tax provided by A.R.S. §§ 42-5061(B)(19) and 42-5159(B)(19) apply to the retail purchase of "[m]achinery or equipment, including related structural components, that is employed in connection with ... processing ... and that is used directly to meet or exceed rules or regulations adopted by ... the United States environmental protection agency, . . . the Arizona department of environmental quality or a political subdivision of this state to prevent, monitor, control or reduce water or air pollution." The 1999 statutory amendment adding "including related structural components" to the machinery and equipment that is exempted by A.R.S. §§ 42-5061(B)(19) and 42-5159(B)(19), applies only to the retail purchase of structural supports and components that are attached to real property for the machinery and equipment at issue, and that are capitalized and depreciated as machinery and equipment for accounting purposes

This private taxpayer ruling cannot make a determination as to whether the listing of machinery and equipment and other items questioned by this ruling request are exempt from transaction privilege tax or use tax, or which specific statutory deduction applies to these purchases, as the information provided about the role and function of these items is inadequate for such a determination. The original private taxpayer ruling request listed broad "work packages" that comprised the project. The Department's letter dated June 10, 2010 requested a description of each item and "*how each* item of the listing qualifies for the exemption(s) at issue." The August 13, 2010 response to the Department's letter again listed broad categories of work (e.g. "upgrade of the building architectural features to support current functionality and building codes," "mechanical - upgrade piping / mechanical to accommodate new equipment / processes," etc.) and did not provide a breakdown of each item and its use in either processing [A.R.S. § 42-5061(B)(1)] or a pollution control processing function [A.R.S. § 42-5061(B)(19)]. Therefore, an itemized response was unfeasible.

The conclusions in this private taxpayer ruling do not extend beyond the facts presented in your correspondences dated April 29, 2010 and August 13, 2010.

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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 private 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. In addition, this private taxpayer ruling only applies to transactions that occur or tax liabilities that accrue from and after the date the taxpayer receives the ruling.

Lrulings/11-004-D