



## PRIVATE TAXPAYER RULING LR17-003

Douglas A. Ducey  
Governor

David Briant  
Director

January 9, 2017

Thank you for your letter dated April 12, 2016, requesting a private taxpayer ruling ("PTR") on behalf of your client, \*\*\*. Specifically, you requested a ruling regarding the applicability of the Arizona transaction privilege tax ("TPT") to the income \*\*\* derives from the construction and installation of \*\*\* and the applicability of the Arizona use taxes to materials purchased for use in constructing the \*\*\*. Pursuant to Arizona Revised Statutes (A.R.S.) § 42-2101, the Department may issue private taxpayer rulings to taxpayers and potential taxpayers on request.

### ISSUES:

To determine the scope of \*\*\*'s taxability for Arizona TPT and use tax purposes the following issues must be addressed:

- Whether the income \*\*\* derives from *only* the construction/fabrication of the \*\*\* is taxable for Arizona TPT purposes?
- Whether the income \*\*\* derives from the construction *and* installation of the \*\*\* is taxable for Arizona TPT purposes?
- Whether the equipment components \*\*\* purchases or brings into Arizona for use in the construction/fabrication of \*\*\* is subject to the Arizona use tax?

### RULING:

Because \*\*\* makes \*\*\* in accordance with its customers' specifications and it may or may not install a \*\*\* after fabrication, each project must be analyzed on a case-by-case basis to determine \*\*\*'s taxability.

When \*\*\* *only* fabricates the \*\*\* because its customer takes care of installation, it is engaging in retail activity as a manufacturer. When that is the case, sales of the \*\*\* to out-of-state customers would likely qualify for the interstate sale exemption. However, sales of the \*\*\* to Arizona customers are taxable as a normal retail sale.

When \*\*\* fabricates *and* installs a \*\*\* for its customer, it is engaging in construction activity since when installed, the \*\*\* will remain in place for the duration of its useful life as an

improvement to real property. \*\*\*'s installation of the \*\*\* may be either non-taxable maintenance, repair, replacement or alteration ("MRRA") work or taxable modification work depending on the circumstances. The installation is modification where the \*\*\* is installed in a new building and it is MRRA activity where the \*\*\* is installed in an existing building. More specifically, when \*\*\* installs the \*\*\* into an existing building it is considered an alteration and would not be taxable *unless* the contract exceeds \$750,000, *or* the work relates to more than 40% of the existing square footage *or* the work expands the existing square footage by more than 10%.

Whether \*\*\* is engaging in contracting or retail/manufacturing activity, it may purchase materials tax exempt for use in fabricating the \*\*\* for both TPT and use tax purposes. A.A.C. R15-5-122 and A.R.S. § 42-5159(A)(4) provide exemptions from the TPT and use taxes respectively for the sale of articles to be incorporated into a fabricated or manufactured product. In addition, A.R.S. § 42-5075(B)(8)(b) allows a retail deduction under A.R.S. § 42-5061(A)(27) for purchases of items by contractors where those items are incorporated into contracting or MRRA projects.

## **SUMMARY OF FACTS:**

The following is a summary of the relevant facts based on your letter dated April 12, 2016, and subsequent correspondence with the Department on June 1, 2016, July 14, 2016, September 15, 2016, together with copies of a typical quote, purchase order and invoice:

\*\*\* was established in \*\*\* by \*\*\*, \*\*\*. It designs customer \*\*\*, primarily \*\*\* and \*\*\* (together "\*\*\*\*" or "\*\*\*\*\*"), at its plant in \*\*\*, \*\*\* and ships them to customers in \*\*\* and \*\*\*.

A \*\*\* consists of a \*\*\* that contains an assortment of \*\*\* components in compliance with customer specifications and includes all \*\*\* necessary for the production of \*\*\*. \*\*\* components are furnished by \*\*\* or its clients.

As part of the typical production process, the \*\*\* components are received at \*\*\*'s plant in \*\*\* where it is inspected. \*\*\* components include a raw painted \*\*\* steel \*\*\* purchased and delivered from a steel fabricator. The steel frame is usually mounted on \*\*\* so that the \*\*\* can \*\*\* during the fabrication process and after the construction process is completed.<sup>1</sup> The customer normally provides other components to be installed on the \*\*\*. Next, large equipment such as the \*\*\* and \*\*\* is installed on the \*\*\*; then smaller equipment is installed. Smaller equipment includes \*\*\*. After the equipment is in place, the \*\*\* of the

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<sup>1</sup> Each \*\*\* typically weighs between 40,000 and 70,000 pounds.

various components is finalized so that the \*\*\* performs consistently with its intended function. \*\*\* is followed by termination of the \*\*\*.

Once production is completed, quality control begins. Measures are in place to ensure the consistent quality of the \*\*\*. Once quality control is complete, the unit is cleaned, then all \*\*\* are \*\*\* and finalized before the unit is wrapped in plastic and prepared for shipment.

Typically, it will take approximately four to six weeks after receipt of a customer's materials to complete one \*\*\* and between eight and twelve weeks for a \*\*\*. The completed \*\*\* is delivered and installed for use at locations in \*\*\* and \*\*\* as well as other locations, including \*\*\*. Clients located outside Arizona do not normally travel to Arizona to negotiate \*\*\* orders.

Installation of the \*\*\* and \*\*\* comprises anchoring and grounding it. As a result of the anchoring and grounding, the \*\*\* are permanently attached at the customer's location for the duration of its useful life.<sup>2</sup> The \*\*\* are removed from the \*\*\* once they are finally set in their permanent location and anchored. The \*\*\* frame itself is anchored and installed below a raised floor.

\*\*\* may handle the on-site installation through the use of a subcontractor or its customers may utilize their own general contractor and/or \*\*\* contractor to complete the installation of the \*\*\*. In either case, a professional rigging firm is hired to off-load the tractor-trailer and physically move the \*\*\* into its final location at the customer's site. Typically, the \*\*\* are primarily installed in new buildings, but may also be installed in existing buildings. \*\*\*'s customers use the \*\*\* to \*\*\* their own \*\*\*.

Once installation is complete, the customer is billed a lump-sum amount for all property and services rendered. Even though the transactions between \*\*\* and its customers are lump-sum amounts, the invoices issued to \*\*\*'s customers do, in fact, break out the charges for all of the services and property furnished in conjunction with the agreed-upon work.

## **DISCUSSION AND LEGAL ANALYSIS:**

### Retail

In a situation where \*\*\* *does not* install the \*\*\*, but only fabricates it and then ships it to the customer's location and the customer engages its own general or \*\*\* contractor to do the installation, \*\*\* would be considered a manufacturer that sells its manufactured products,

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<sup>2</sup> The \*\*\* are always anchored to the building per seismic requirements.

the \*\*\*. It would be conducting retail activity and would be taxable under the retail classification.

A.R.S. § 42 5061 imposes the TPT on the business of selling tangible personal property at retail. "Selling at retail" is defined by A.R.S. § 42 5061(V)(3) as a sale for any purpose other than for resale in the regular course of business. The tax base is the gross proceeds of sales or gross income derived from the business. A.R.S. § 42-5001(14) defines "sale" in part, "as any transfer of title or possession, or both ... conditional or otherwise, in any manner or by any means whatever, including ... fabricating tangible personal property for consumers who furnish either directly or indirectly the materials used in the fabrication work." Thus, when \*\*\* sells the \*\*\*, it would be responsible for the TPT on the income derived from the sale under the retail classification unless an exemption or deduction applies. This is true even though \*\*\*'s customers provide some of the component parts of the \*\*\* to \*\*\* to facilitate the fabrication.

A.R.S. § 42-5061(B) details a number of deductions for the income derived from the sale of certain machinery and equipment. For example, A.R.S. § 42-5061(B)(\*\*\*) provides an exemption \*\*\*. \*\*\*.<sup>3,4</sup> So whether machinery and equipment that \*\*\*. While it appears that the systems \*\*\* fabricates and installs are primarily \*\*\* systems, given the fact that \*\*\*, it is unlikely that \*\*\*'s \*\*\* would qualify for the exemption since its \*\*\* are used by single customers for \*\*\* purposes. However, \*\*\* would have to analyze each custom \*\*\*.

A.R.S. § 42-5061(A)(24) provides a deduction for the income derived from the sale of tangible personal property sold in interstate or foreign commerce. To qualify as a sale in interstate commerce, A.A.C. R15-5-170(A) provides that the order must be received from a location outside of Arizona and the retailer must ship or deliver the tangible personal property to a location outside of Arizona for use outside of Arizona. When \*\*\* sells the \*\*\* to customers *outside* Arizona, *and* the requirements of A.A.C. R15-5-170 are satisfied then such a sale would be exempt as occurring in interstate commerce. \*\*\*. Sales to Arizona customers, however, would be fully taxable under the retail classification \*\*\*.

### Contracting

In addition to selling \*\*\* without installing them, \*\*\*, in some cases, also fabricates *and* installs the \*\*\* for some of its customers through the use of subcontractors. The case of *Brink Electric Construction Co. v. Arizona Department of Revenue*, 909 P.2d 421, 427, 184 Ariz. 354, 360 (Ariz. App. Div. 1, 1995) is helpful in analyzing whether this activity changes

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<sup>3</sup> See \*\*\*.

<sup>4</sup> See \*\*\*.

\*\*\*'s taxable classification from being only a retailer to also conducting contracting activity. In *Brink*, the taxpayer contended that its furnishing and installation of electrical transmission equipment at substations did not constitute the business of contracting because the various items it installed were merely set down or bolted down and could be moved to other locations without damage. The court held that the relative degree of permanency with which the equipment and materials attached or affixed was not the issue because the permanency required for a finding of contracting activity was not equated with perpetuity. It was sufficient if the item was intended to remain where affixed until worn out, until the purpose to which the realty is devoted is accomplished or until the item is superseded by another item more suitable for the purpose.<sup>5</sup> The court noted that the equipment Brink supplied was clearly intended to remain where installed "until the purpose to which the realty is devoted is accomplished."<sup>6</sup> Thus, Brink engaged in the business of contracting when it installed this equipment, and was subject to the TPT on its contracting activity.

In this case, when \*\*\* fabricates the \*\*\* on wheels and later installs it by bolting and grounding, it is performing contracting work because when bolted and grounded it remains in its location "until the purpose to which the realty is devoted is accomplished;" i.e. for the rest of its useful life. As a result, where \*\*\* fabricates *and* installs the \*\*\* the contracting classification applies.

A.R.S. § 42-5075 imposes TPT on "the business of prime contracting." Fundamentally, prime contracting TPT can be understood as a tax on service activities. The tax base for the prime contracting classification is sixty-five percent of a prime contractor's gross receipts derived from the business. See A.R.S. § 42-5075(B).

The term "contracting" means "engaging in business as a contractor."<sup>7</sup> A.R.S. § 42 5075(R)(3) provides that a "contractor" is synonymous with the term "builder" and means any person or organization that undertakes to or offers to undertake to, or purports to have the capacity to undertake to, or submits a bid to, or does personally or by or through others, modify any building. Under A.R.S. § 42-5075(R)(6) "modification" means construction, grading and leveling ground, wreckage or demolition. Under A.R.S. § 42-5075(R)(7), "modify" means to make a modification or cause a modification to be made.

A.R.S. § 42-5075(O) provides that the prime contracting classification *does not include* the gross proceeds of sale or gross income derived from a contract with the owner of real

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<sup>5</sup> See *Brink*, 909 P.2d 421, 428, 184 Ariz. 354, 361 (Ariz. App. Div. 1, 1995) quoting *Matter of Tax Appeal of Logan and Associates*, 331 N.W.2d 281, 283 (S.D. 1983).

<sup>6</sup> *Id.*

<sup>7</sup> A.R.S. § 42 5075(R)(2).

property for MRRA projects provided the contract does not include modification activities. A.R.S. § 42-5075(O) created a new class of non-taxable contracting activity, i.e. MRRA activity. Taxable modifications now essentially encompass “ground up” construction, grading and leveling ground, and wreckage or demolition activities, to the extent they cannot otherwise be characterized as MRRA activities.

The \*\*\* are normally installed in new buildings, but may also be installed in existing buildings. As a result, depending on whether a new or existing building is in question, the installation of the \*\*\* could potentially be *either* a modification or MRRA project. When the \*\*\* are installed in new buildings, the installation would be modification activity and taxable unless an exemption applies. When the \*\*\* are installed in existing buildings, the installation would be MRRA activity, specifically an alteration. This alteration activity is non-taxable unless certain conditions are *not* met. Specifically, for commercial properties,<sup>8</sup> non-taxable alterations become taxable if *any* of the following apply:

- (i) The contract amount is more than seven hundred fifty thousand dollars (\$750,000);
- (ii) The scope of work directly relates to more than forty percent of the existing square footage of the existing property; or
- (iii) The scope of work involves expanding the square footage of more than ten percent of the existing property.

Installations taking place *outside* Arizona are *not* taxable for Arizona TPT contracting purposes as contracting activity must take place in Arizona.

A.R.S. § 42-5075(B), which details deductions from the prime contracting base, allows the cost of certain tangible personal property purchased in connection with prime contracting projects, and in some cases, income from certain contracting projects, to be deducted from the prime contracting tax base. In this case, the potential for any deductions is negated by the fact that the \*\*\* built and, in some cases, installed, by \*\*\* would not likely qualify as exempt machinery and equipment under A.R.S. § 42-5061(B).<sup>9</sup>

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<sup>8</sup> The Department assumes, that because of the nature of the \*\*\*, they are used only in commercial properties.

<sup>9</sup>Two potential sections could have applied in this case. However, to qualify for either of these exemptions, the machinery and equipment would also have to be exempt under A.R.S. § 42-5061(B), \*\*\*. A.R.S. § 42-5075(B)(7) provides a deduction from the prime contracting tax base for the gross income derived from a contract for the installation, assembly, repair or maintenance of machinery, equipment that is exempt under A.R.S. § 42-5061(B) and has independent functioning utility (“IFU”). A.R.S. § 42-5075(B)(8) provides a deduction for gross income attributable to the purchase of machinery equipment or other tangible personal property that is exempt under A.R.S. § 42-5061(B).

### Exemption from TPT or Use Tax on the Purchase of Materials

In relation to \*\*\*'s *retail* activity, A.A.C. R15-5-122 provides an exemption from the retail classification for sales of articles that are incorporated into a fabricated or manufactured product. A.R.S. § 42-5159(A)(4) provides a similar exemption from the use tax. In order for the exemption to apply, the materials must actually become a part of the finished product. Supplies which are consumed in the manufacturing process do not qualify. In this case, \*\*\* would be able to purchase materials exempt from retail TPT and use taxes when those materials become a part of the \*\*\*. Thus, it does not owe use taxes on the materials it buys or brings into Arizona to make the \*\*\* (e.g. \*\*\* etc.). Likewise, it may purchase materials tax exempt for use in fabricating the \*\*\*. This is true for \*\*\* fabricated for Arizona customers as well as for customers outside of Arizona.

In relation to \*\*\*'s *contracting* activity, A.R.S. § 42-5061(A)(27) provides a deduction under the retail classification for materials purchased by contractors to be used in a modification or MRRA project. A similar exemption is allowed for use taxes for contractors purchasing materials to be used in modification or MRRA projects. See A.R.S. § 42-5159(A)(13)(g). Thus, when \*\*\* purchases materials in Arizona it can do so tax exempt under A.R.S. § 42-5061(A)(27). Additionally, if it brings materials into Arizona to be used to fabricate \*\*\* on an installation project, it is not responsible for the Arizona use tax on the purchase and use of the materials in a modification or MRRA project under A.R.S. § 42-5159(A)(13)(g). This is true whether the installation of the \*\*\* takes place inside or outside Arizona. It is important to note here that the above provisions only allow for the exempt purchases of materials for modification or MRRA projects, they do not also provide a deduction from the prime contracting tax base.

### Conclusion

Because \*\*\* makes \*\*\* in accordance with its customers' specifications and it may or may not install a \*\*\* after fabrication, each project must be analyzed on a case-by-case basis.

Where \*\*\* only fabricates and sells the \*\*\* but installation is done by the customer, \*\*\* is engaging in retail activity. When \*\*\* sells the \*\*\*, it would be responsible for the TPT on the income derived from the sale under the retail classification. This is true even though \*\*\*'s customers provide some of the component parts of the \*\*\* to \*\*\* to facilitate the fabrication.

When \*\*\* fabricates *and* installs a \*\*\* for its customer, it is engaging in construction activity since when installed, the \*\*\* will remain in place for the duration of its useful life as an

improvement to real property. \*\*\*'s installation of the \*\*\* may be either non-taxable MRRA work or taxable modification work depending on the circumstances. The installation is modification where the \*\*\* is installed in a new building, and MRRA activity where the \*\*\* is installed in an existing building. Installation in existing buildings is alteration activity and would not be taxable unless the contract exceeds \$750,000, or the work relates to more than 40% of the existing square footage or the work expands the existing square footage by more than 10%.

Whether \*\*\* is engaging in contracting or retail activity, the materials it buys or brings into Arizona for use in fabricating the \*\*\* may be purchased TPT and use tax exempt.

**This response is a private taxpayer ruling and the determinations herein are based solely on the facts provided in your request. Therefore, the conclusions in this private taxpayer ruling do not extend beyond the facts presented in your correspondence. 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.**