



## TAXPAYER INFORMATION RULING LR 19-006

Douglas A. Ducey  
Governor

Carlton Woodruff  
Director

December 30, 2019

Thank you for your letter requesting a taxpayer information ruling (“TIR”) on behalf of your unnamed client (“Taxpayer”). Specifically, you requested a ruling on whether Taxpayer’s gross income derived from sale of third party manufactured items of tangible personal property to the United States Government (“Government”) are subject to Arizona’s transaction privilege tax (“TPT”) where Taxpayer is also a manufacturer of tangible personal property. Pursuant to Arizona Revised Statutes (“A.R.S.”) § 42-2101, the Arizona Department of Revenue (“Department”) may issue taxpayer information rulings to taxpayers and potential taxpayers on request.

### ISSUE:

Whether Taxpayer’s gross income derived from sales to the Government of tangible personal property are subject to TPT in the following:

1. A sale to the Government of tangible personal property manufactured by Taxpayer.
2. A resale to the Government of tangible personal property manufactured by a third party.

### RULING:

#### The Department Rules as follows:

1. Sales to the Government of tangible personal property manufactured by Taxpayer are fully deductible under A.R.S. § 42-5061(I)(1).
2. Sales to the Government of tangible personal property for which Taxpayer is a reseller of another’s manufactured goods are allowed a fifty percent deduction under A.R.S. § 42-5061(J).

### SUMMARY OF FACTS:

The following is a summary of the relevant facts based on your letter dated March 26, 2019 and received on April 1, 2019, together with subsequent correspondence with the Department received on April 30, 2019, May 21, 2019 and August 6, 2019:

Taxpayer is incorporated in \*\*\* with manufacturing operations in \*\*\*. Previously, Taxpayer had no substantial nexus with Arizona and has not collected TPT on sales in Arizona. Taxpayer, if not currently, will soon establish substantial nexus with Arizona due to employee relocations into the state. Taxpayer, is in the business of manufacturing and selling \*\*\*. Additionally, Taxpayer has a line of business fulfilling Government contacts with goods manufactured by third parties and resold by Taxpayer.

Taxpayer enters into \*\*\* contracts with the Government to provide items of tangible personal property. \*\*\* is a program developed by \*\*\* to provide logistics support and procurement for the Government.<sup>1</sup> All contracts through TLS are fulfilled using items manufactured by third parties and resold by Taxpayer. Goods are shipped to various Government locations both within and without Arizona.<sup>2</sup> Completed contracts are invoiced to the Government \*\*\* and received at a central Government location. Taxpayer's sales to the Government include the following:

- Various \*\*\* manufactured by Taxpayer, not included in a \*\*\* contract, and sold and shipped to the Government.
- Items of a wide range such as \*\*\*, ("Third Party Items") and not manufactured by Taxpayer. These items are included in a \*\*\* contract and are either: (1) shipped to Taxpayer's warehouse and then shipped to the Government; or (2) shipped directly by the third party to the Government.<sup>3</sup>

Taxpayer's TLS contract's made up approximately 60% of Taxpayer's gross income in 2018, 50% in 2017, 45% in 2016 and 40% in 2015. Taxpayer's position is that, as a manufacturer of goods, all gross income derived from sales to the Government, whether manufactured by Taxpayer or another manufacturer, are exempt from TPT.

## **DISCUSSION AND LEGAL ANALYSIS:**

Arizona's TPT differs from the sales tax imposed by most states. It is a tax on the privilege of conducting business in the State of Arizona. Differing from a true sales tax, the TPT is levied on income derived by the seller, who is legally allowed to pass the economic expense of the tax on to the purchaser. However, the seller is ultimately liable to Arizona for the tax. The Arizona TPT is imposed under sixteen separate business classifications. County excise taxes "piggyback" the imposition of the state's TPT. All sales subject to TPT are also subject to applicable county excise taxes.

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<sup>1</sup> \*\*\*

<sup>2</sup> Of these transactions, 95% to 99% are drop shipped by the third party vendor on behalf of Taxpayer.

<sup>3</sup> These items are not used in manufacturing, nor are they modified, assembled or repaired by Taxpayer on behalf of the Government.

A.R.S. § 42-5061 imposes TPT under the retail classification. The retail classification is comprised of the business of selling tangible personal property at retail. The tax base for the retail classification is the gross proceeds of sales or gross income derived from the business. A.R.S. § 42-5061(V)(4) defines “selling at retail” as “a sale for any purpose other than for resale in the regular course of business in the form of tangible personal property.” A.R.S. § 42-5001(21) defines “tangible personal property” as “personal property which may be seen, weighed, measured, felt or touched or is in any other manner perceptible to the senses.” All sales of tangible personal property are subject to the TPT under the retail classification unless specifically deductible or excluded by statute.

A.R.S. § 42-6017 addresses the city privilege taxes in relation to the retail classification. It provides that “[e]xcept as provided in this section, section 42-5061 supersedes all city or town ordinances or other local laws insofar as the ordinances or local laws now or hereafter relate to the taxation of business activities classified under section 42-5061.” That section also provides certain exceptions where a city may exempt or tax specific items that are not taxable or exempt by the state provisions. None of the specified exemptions in A.R.S. § 42-6017 pertain to sales to the Government and the state provisions apply for city privilege taxes.

#### United States Constitution - Supremacy Clause

The Supremacy Clause (Article VI) of the United States Constitution prevents states from levying taxes directly on the Government. It does not, however, prevent the imposition of a tax which indirectly burdens the Government. Therefore, imposition of Arizona’s TPT upon a retailer selling to a branch or agency of the federal government has been upheld by the courts, regardless of the fact that the Government may bear the economic burden of the tax. See *Arizona State Tax Commission v. Garrett Corp.*, 79 Ariz. 389, 291 P.2d 208 (1955); see also *United States v. California*, 507 U.S. 746 (1993); *United States v. New Mexico*, 455 U.S. 720 (1982).

As stated above, the U.S. Constitution prohibits a state from imposing a tax if the legal incidence of the tax falls directly on the Government. However, TPT is a tax on the privilege of conducting business in the State of Arizona. It is a tax on the seller, not on the purchaser. Because the tax is not imposed on the Government, the constitutional immunity of the United States does not apply. Therefore, the gross receipts of a vendor that are derived from retail sales to the Government are subject to TPT unless specifically excluded or deductible by statute.

The Arizona Administrative Code (“A.A.C.”) R15-5-181(A) provides that “[g]ross receipts from the sale of tangible personal property to the Federal Government or its departments and agencies are taxable at the rate prescribed by statute, unless otherwise exempt.” Thus, retail sales to the Federal government are subject to Arizona TPT unless a deduction applies.

### Deductions on Sales to the Federal Government

Prior to 1955, various courts considered whether TPT was called a transaction privilege tax but in reality acted as a sales tax which would have been a violation of the supremacy clause.<sup>4</sup> The *Garrett* decision put this issue to rest.<sup>5</sup> Shortly after the Court’s decision, the Arizona house and senate each introduced bills to allow for deductions on sales to the Government (prior to this time all sales to the Government were fully subject to TPT). The House’s bill would have only allowed a deduction on sales to the Government where the goods sold were manufactured in Arizona and sold by the actual manufacturer of the goods<sup>6</sup>. The Senate’s bill would have provided for a full deduction on any sale, by any retailer, to the Government.<sup>7</sup>

A compromise was introduced creating two deductions by incorporating from both the House and Senate bills. The first deduction was a modification of the House bill to allow a full deduction to sales of tangible personal property to the Government by the person or company who manufactured, modified, assembled or repaired the items. The second deduction was a modification of the Senate bill to allow an exemption of fifty percent on any item of tangible personal property sold by any person to the Government.<sup>8</sup> The proposed bill passed and is codified in A.R.S. §§ 42-5061(I)(1) and (J).

A.R.S. § 42-5061(I)(1) allows a deduction from the tax base on the gross income derived from sales made directly to the United States government or its departments or agencies by a manufacturer, modifier, assembler or repairer (“Manufacturer”).<sup>9</sup>

A.R.S. § 42-5061(J) allows a deduction from the tax base of fifty percent of the gross proceeds of sale or gross income from any sale made directly to the United States Government that is not already deducted under A.R.S. § 42-5061(I).<sup>10</sup>

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<sup>4</sup> *Tax on Sales to Government Ruled Unconstitutional*, THE MESSENGER, Oct. 18, 1955, at 1.

<sup>5</sup> 79 Ariz. at 396. In reaching their ruling, the Arizona Supreme Court cited to a number of other states’ supreme courts whose decisions reached the same conclusion.

<sup>6</sup> RICHARDS, *supra* n.7.

<sup>7</sup> *Id.* at 12.

<sup>8</sup> *Id.* at 12-13

<sup>9</sup> Originally codified as A.R.S. § 73-1329(b)(1).

<sup>10</sup> Originally codified as A.R.S. § 73-1329(c).

Laws 1988, Chapter 161, created a full deduction on a sale directly to the Manufacturer of any ingredient or component part to be incorporated into property sold directly to the federal government under A.R.S. § 42-5061(I)(2).

Laws 1994, Chapter 377, introduced deductions for the sale of overhead materials to be used in performing a Government contract. A.R.S. § 42-5061(I)(3) allows a deduction on overhead materials or other tangible personal property that are used to perform certain contracts between the federal government and a Manufacturer where title in the property passes to the government. A.R.S. § 42-5061(I)(4) allows a deduction on the sale of overhead materials to a Manufacturer if the gross proceeds of sales derived from the property will be exempt under A.R.S. 42-5061(I)(3).

Overhead material is defined by A.R.S. § 42-5061(W)(4) to mean tangible personal property which would otherwise be subject to TPT under the retail classification “that are used or consumed in the performance of a contract, the cost of which is charged to an overhead expense account and allocated to various contracts based on generally accepted accounting principles and consistent with government contract accounting standards.”

A.R.S. § 42-5061(W)(2) defines a manufacturer to mean “a person who is principally engaged in the fabrication, production or manufacture of products, wares or articles for use from raw or prepared materials, imparting to those materials new forms, qualities, properties and combinations.”

### Discussion

The Arizona Supreme Court has stated that “[w]hen interpreting statutes, we strive to ‘discern and give effect to legislative intent.’<sup>11</sup> We ‘construe the statute as a whole, and consider its context, language, subject matter, historical background, effects and consequences, [as well as] its spirit and purpose.’”<sup>12</sup> The historical background on sales to the Government shows the legislature intended to restrict the full deduction, A.R.S. § 42-5061(I)(1), to the sale of tangible personal property to the Government by the actual Manufacturer of the item. As part of the compromise A.R.S. 42-5061(J), which allows a fifty percent deduction, was intended as a comprehensive deduction for any other sale of tangible personal property to the Government by a retailer.

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<sup>11</sup> *State ex rel. Arizona Dept. of Revenue v. Capitol Castings, Inc.*, 207 Ariz. 445 (2004) (citing to *People’s Choice TV Corp. v. City of Tucson*, 202 Ariz. 401, 403, ¶ 7, 46 P.3d 412, 414 (2002)).

<sup>12</sup> *Id.* (quoting *State ex rel. Ariz. Dep’t of Revenue v. Phoenix Lodge No. 708, Loyal Order of Moose, Inc.*, 187 Ariz. 242, 247, 928 P.2d 666, 671 (App.1996)

Accordingly, tangible personal property manufactured *by* Taxpayer (*i.e.*, \*\*\*) and sold directly to the Government is not a taxable transaction by either state, county or municipalities.

Tangible personal property manufactured by a third party, purchased by Taxpayer, and resold to the Government without any involvement by Taxpayer in manufacturing, modifying, assembling or repairing of the Third Party Items is considered a retail transaction and is allowed a fifty percent deduction from state, county and municipality privilege taxes.

Should Taxpayer purchase tangible personal property to be used as an ingredient or component part in manufacturing items of tangible personal property which are then sold directly to the Government, or purchase overhead materials for use in fulfilling a contract with the Government to provide items of tangible personal property, these transactions would not be taxable by either the state, county or municipalities.

**This response is a taxpayer information ruling (TIR) and the determination herein is based solely on the facts provided in your request. The determinations are subject to change should the facts prove to be different on audit. If it is determined that undisclosed facts were substantial or material to the Department's making of an accurate determination, this taxpayer information 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.**

**If the Department is provided with required taxpayer identifying information and taxpayer representative authorization before the proposed publication date (for a published TIR) or date specified by the Department (for an unpublished TIR), the TIR will be binding on the Department with respect to the taxpayer that requested the ruling. In addition, the ruling will apply only to transactions that occur or tax liabilities that accrue from and after the date the taxpayer receives the ruling. The ruling may not be relied upon, cited, or introduced into evidence in any proceeding by a taxpayer other than the taxpayer who has received the taxpayer information ruling. If the required information is not provided by the specified date, the taxpayer information ruling is non-binding for the purpose of abating interest, penalty or tax.**