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ARIZONA TRANSACTION PRIVILEGE TAX RULING TPR 23-1

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Date Proposed: April 8, 2022

Date Final: April 7, 2023

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Issue:

What constitutes a prosthetic appliance exempt from the retail transaction privilege tax ("TPT") classification under Arizona Revised Statutes ("A.R.S.") § 42-5061(A)(9)¹ following the Arizona Court of Appeals decision in *VHS Acquisition Subsidiary Number 1 Inc. v. Arizona Department of Revenue*, No. 1 CA-TX 20-0007, 2021 WL 1747353 (App. May 4, 2021)?

Ruling Summary:

Prosthetic appliances exempt from the retail TPT classification are those artificial devices prescribed or recommended by licensed health professionals, which devices are necessary to support or take the place of a part of the body, or to increase the acuity of a sense organ. A.R.S. §§ 23-501(7), 42-5061(A)(9). Further, exempt prosthetic appliances include those devices that are necessary to integrated prosthetic processes (e.g., equipment, supplies, and solutions necessarily used in the integrated process of kidney dialysis) or that are necessary to apply a prosthetic appliance. *Renal West v. Ariz. Dep't of Revenue*, 189 Ariz. 409, 414 (App. 1997); *VHS Acquisition*, No. 1 CA-TX 20-0007, 2021 WL 1747353, ¶ 25.

¹ Pursuant to A.R.S. §§ 42-6017 and 42-6130, Arizona's TPT statutes govern the imposition of county excise and city privilege taxes as it pertains to the retail classification and its deduction for prosthetic appliances. Accordingly, this ruling also applies to the deduction from county excise and city privilege taxes for retail sales of prosthetic appliances. Further, A.R.S. § 42-5159(A)(17) contains a parallel exemption from Arizona use tax for the storage, use, or consumption of prosthetic appliances. Accordingly, this ruling also applies to the exemption from use tax for prosthetic appliances.

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Applicable Law:

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. All sales of tangible personal property are subject to TPT under the retail classification unless specifically exempted or deductible by statute.²

A.R.S. § 42-5061(A)(9) exempts from the retail classification “[p]rosthentic appliances as defined in § 23-501 prescribed or recommended by a health professional licensed pursuant to title 32, chapter 7, 8, 11, 13, 14, 15, 16, 17 or 29.” These chapters refer to podiatrists, doctors of chiropractic, dentists, physicians and surgeons, naturopathic physicians, nurses, osteopathic physicians and surgeons, and homeopathic physicians.³

A.R.S. § 23-501(7), in turn, defines a “prosthetic appliance” as “an artificial device necessary to support or take the place of a part of the body, or to increase the acuity of a sense organ.”

Arizona Administrative Code (“A.A.C.”) R15-5-156(A)(12) further defines a “prosthetic appliance” as “an artificial device that fully or partially replaces a part or function of the human body or increases the acuity of a sense organ.” In *VHS Acquisition*, citing its previous definitions and ruling in *Renal West*, the Arizona Court of Appeals used the *Webster’s Ninth New Collegiate Dictionary* to define “device” as a “mechanism designed to serve a special purpose or perform a special function,” and “mechanism” as a “process or technique for achieving a result.” No. 1 CA-TX 20-0007, 2021 WL 1747353, ¶ 11.

A.A.C. R15-5-156(B)(4) provides that gross receipts from sales of “prosthetic appliances,” prescribed or recommended by a statutorily-authorized individual, are not subject to tax. Additionally, A.A.C. R15-5-156(C) exempts the sale of “component and repair parts” of prosthetic appliances. Therefore, items that meet the definition of a prosthetic appliance, or a component or repair part of an exempt prosthetic appliance, are exempt from Arizona TPT.

Application of Use Tax and TPT Exemptions for Prosthetic Appliances

In *Renal West*, the court addressed whether kidney dialysis machines, solutions, testing equipment, and supplies constitute exempt prosthetic appliances. See 189 Ariz. at 409-16. The court determined that: (1) “processes” may fall within the meaning of “prosthetic appliance”; (2) the dialysis process is within the meaning of prosthetic appliance because it replaces the process performed by the kidneys; and (3) all equipment, supplies, and

² Arizona also applies use tax on the “storage, use or consumption in this state of tangible personal property purchased from a retailer or utility business, as a percentage of the sales price.” A.R.S. § 42-5155.

³ Similarly, the use tax exemption in A.R.S. § 42-5159(A)(17) exempts “[p]rosthentic appliances, as defined in A.R.S. § 23-501, prescribed or recommended by a person who is licensed, registered or otherwise professionally credentialed as a physician, dentist, podiatrist, chiropractor, naturopath, homeopath, nurse or optometrist.”

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solutions essential to the dialysis process are therefore prosthetic appliances. *Id.* at 414. The court broadly interpreted the definition of prosthetic appliances to include items that were necessary to the integrated process of dialysis. *Id.* Accordingly, the court determined that the use of the items used in dialysis constitute devices necessary to substitute for failed kidneys, as they were all necessary parts of the integrated process of dialysis, and thus qualified for the prosthetic appliance exemption. *Id.*

In *VHS Acquisition*, the court examined whether adhesive skin closures, liquid skin adhesives, mesh fixation devices, bone wax, surgical clips, ligature loops, staples, and sutures⁴ qualify as exempt “prosthetic appliances.” See *generally*, No. 1 CA-TX 20-0007, 2021 WL 1747353, ¶¶ 8-21. Rejecting the Department’s argument that these items would only constitute “medical and surgical supplies” as separately defined in A.R.S. § 23-501(6), the court determined that each of these items also were included in the definition of “prosthetic appliance” because they were necessary components of particular bodily processes—those that support, keep together, seal, and otherwise contain bodily fluids like skin and other body tissues do in the body, and that additionally facilitate healing. *Id.*

The court in *VHS Acquisition* further broadened its definition of “prosthetic appliances” when it ruled that items *necessary to apply* prosthetic appliances also fall within the definition and thus are exempt from Arizona TPT and use tax. *Id.* ¶¶ 22-31. In this case, the court stated that these items included preloaded mesh fixation, clip applicators, staplers, suture devices, pens, and ampules used to apply the above items that kept body tissues together and sealed. *Id.* The court said the facts were analogous to the “complicated, integrated process” of kidney dialysis in *Renal West* and the central holding in that case that “essential parts of a prosthetic process are prosthetic appliances” applied. *Id.* ¶ 24. So, even though the items used to apply prosthetic appliances are not “prosthetic appliances” when viewed in isolation, they still fall within the definition and exemption of “prosthetic appliances” because they are necessary for the safe application of such appliances. *Id.* ¶ 25.

The court in *Renal West* addressed the requirement that a prosthetic appliance must be “prescribed or recommended by” a licensed health professional under A.R.S. § 42-5159(A)(17) (the parallel use tax exemption to the retail TPT deduction in A.R.S. § 42-5061(A)(9)). 189 Ariz. at 412-415. In that case, the dialysis center was the party claiming the use tax exemption rather than the individual patient, even though the dialysis center was not the party with the prescription or recommendation. The court acknowledged that individuals holding prescriptions routinely (1) directly purchase or use prosthetic appliances for their own personal use, but also (2) may go to health care providers who purchase the prosthetic appliances and then use them to treat the individual. The court ruled that it was appropriate for the dialysis center to claim the exemption even though they themselves did not have the prescription because “the statutory language defines the *type* of appliances exempt from tax, rather than *who* receives the exemption.” *Id.* at 412. Accordingly, health care providers may claim the prosthetic appliance exemption, even though the prosthetic appliance was not

⁴ Each of these items support, seal, or otherwise keep together various body tissues.

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prescribed or recommended to them, so long as the prosthetic appliance was prescribed or recommended by the licensed health professional to the patient.

County Excise and Municipal Privilege Taxes

A.R.S. § 42-6103 provides that the state's TPT provisions shall govern the imposition of county excise taxes. Accordingly, all sales subject to TPT are also subject to applicable county excise taxes.

The imposition of city privilege taxes is separate and distinct from the imposition of the state's TPT and accompanying county excise taxes. However, like the state's TPT, city privilege taxes are also imposed on the vendor for the privilege of engaging in business in the city. The Model City Tax Code ("MCTC") was created in order to impose and administer city privilege taxes. Similar to Arizona's TPT, city privilege taxes are imposed "upon persons on account of their business activities." MCTC § -400(a)(1). All Arizona cities follow the MCTC in their imposition of the privilege tax based upon their local ordinances.

A.R.S. § 42-6017 addresses the city privilege taxes in relation to the retail classification. Effective October 1, 2019, 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 in which a city may exempt or tax specific items that are not taxable or exempt by the state provisions, but prosthetic appliances are not included within those exceptions. Accordingly, A.R.S. § 42-5061(A)(9) also governs the imposition of city privilege tax on prosthetic appliances.

Discussion:

As laid out above, A.R.S. § 42-5061(A)(9) exempts "prosthetic appliances" from TPT on a retail sale. "Prosthetic appliances" are defined as artificial devices necessary to support or take the place of a part of the body, or to increase the acuity of a sense organ. See A.R.S. § 23-501. Further, A.A.C. R15-5-156 defines a "prosthetic appliance" as "an artificial device which fully or partially replaces a part or function of the human body or increases the acuity of a sense organ." Note that the statutory definition requires that the prosthetic appliance be artificial, so it would not include transplanted organs or body parts.

The courts in *Renal West* and *VHS Acquisition* further explained that the definition of "prosthetic appliances" includes equipment, supplies, and solutions necessary to integrated prosthetic processes, such as kidney dialysis, as well as items necessary to apply prosthetic appliances, even when such items by themselves may not be prosthetic appliances. *Renal West*, 189 Ariz. at 409-16; *VHS Acquisition*, No. 1 CA-TX 20-0007, 2021 WL 1747353, ¶¶ 22-31.

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Based on the relevant statutes, administrative rules, and court rulings referenced above, the Department advises using the following guidelines to determine whether a device meets the definition of “prosthetic appliance” provided under A.R.S. § 42-5061(A)(9)^{5,6}:

1. Identify if the device is “prescribed or recommended by a licensed podiatrist, chiropractor, dentist, physician or surgeon, naturopath, optometrist, osteopathic physician or surgeon, psychologist, hearing aid dispenser, physician assistant, nurse practitioner or veterinarian.” A.R.S. § 42-5061(A)(9). Note that the party claiming the exemption does not have to be the party holding the prescription or recommendation, as per *Renal West*. This scenario would apply in the case of a medical or other healthcare facility purchasing equipment to be used on patients to whom the prosthetic appliance was prescribed or recommended by the licensed health professional. If a non-licensed professional or other individual purchases the device, that person must show that the prosthetic was prescribed or recommended by a healthcare professional.
2. Identify whether the device is artificial; the exemption does not include human or other naturally occurring tissue.
3. Identify the body part or body function the device is seeking to support or replace.
4. Identify whether the device is necessary to support that part of the body or body function, take the place of that part of the body or body function, or if the device increases the acuity of one of the senses.
5. If the device is necessary to support a part of the body or function, take the place of a part of the body or function, or increase the acuity of one of the senses, it would qualify as a “prosthetic appliance” under A.R.S. § 42-5061(A)(9).
6. Even if a particular device does not appear to directly qualify as a “prosthetic appliance” under the analysis, above, analyze whether the device is (1) an essential part of an integrated prosthetic process (e.g., equipment, supplies, and solutions necessarily used in the integrated process of kidney dialysis) that satisfies the elements of a prosthetic appliance as described above, or (2) necessary to apply a prosthetic appliance, as such items also qualify for the “prosthetic appliance” exemption under A.R.S. § 42-5061(A)(9) under the broad meaning Arizona courts have applied to the term “device.” See *generally Renal West*, 189 Ariz. 409; *VHS Acquisition*, No. 1 CA-TX 20-0007, 2021 WL 1747353.

⁵ This analysis would also be applicable to the definition of “prosthetic appliance” under the use tax exemption for the same under A.R.S. § 42-5159(A)(17).

⁶ Whether the prosthetic appliance exemption applies to bundled kits containing both exempt and non-exempt items shall be addressed on a case-by-case basis depending on the specific kit in question.

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Ruling:

Prosthetic appliances exempt from the retail TPT classification are those artificial devices prescribed or recommended by licensed health professionals, which devices are necessary to support or take the place of a part of the body, or to increase the acuity of a sense organ. A.R.S. § 23-501(7). Further, exempt prosthetic appliances include those devices that are necessary to integrated prosthetic processes such as dialysis (e.g., equipment, supplies, and solutions necessarily used in the integrated process of kidney dialysis) or are necessary to apply a prosthetic appliance. *Renal West*, 189 Ariz. at 414; *VHS Acquisition*, No. 1 CA-TX 20-0007, 2021 WL 1747353, ¶ 25.

To substantiate the prosthetic appliance exemption from TPT, county excise tax, and city privilege tax under A.R.S. § 42-5061(A)(9),⁷ a person must be able to show, through a proper exemption certificate per A.R.S. § 42-5009(A) and as discussed in detail in *Arizona Transaction Privilege Tax Procedure* TPP 17-1, or through other acceptable substantiating documentation as discussed below, that the device falls under the definition of a prosthetic appliance (as discussed in detail above).

Under A.R.S. § 42-5009(B), “A person who does not comply with subsection A of this section [*i.e.*, marking the invoice as being deducted from the tax base and obtaining a proper exemption certificate from the purchaser] may establish entitlement to the deduction by presenting facts necessary to support the entitlement, *but the burden of proof is on that person*” (emphasis added). For prosthetic appliances, required product labeling and directions for intended uses under U.S. Food and Drug Administration (“FDA”) regulations,⁸ in certain circumstances, may be used to support entitlement to the deduction for a particular device. For example, FDA product labeling that requires a prescription from a licensed health professional (“Rx only”) in order to sell a particular item to a patient or customer may be used to substantiate the requirement that the prosthetic appliance was prescribed or recommended by a licensed health professional. Further, documentation that shows the vendor is a licensed health care provider, or that the purchaser is a licensed health care provider, who—because of their status as a licensed health care provider—only sells or uses an item under a prescription or recommendation of a licensed health professional, may also substantiate the requirement that the prosthetic appliance was prescribed or recommended by a licensed health professional.

FDA-required directions for intended uses provided with an item or device may also be used by a taxpayer to show that an item is a prosthetic appliance because it is necessary to

⁷ This ruling is also applicable to the parallel use tax exemption for prosthetic appliances under A.R.S. § 42-5159(A)(17).

⁸ The FDA regulates medical device labeling and directions for use. Under 21 C.F.R. § 801, *et seq.*, and subject to the provisions therein and other statutes and regulations, manufacturers of certain medical devices are required to put certain information on product labels, including whether the device may only be sold by prescription (“Rx only”) and directions for intended uses of such device.

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support or take the place of a part of the body, increase the acuity of a sense organ, necessary to an integrated prosthetic process, or necessary to apply a prosthetic appliance. Note, however, that a particular device may have more than one intended use, including uses that do not qualify the device as a prosthetic appliance. In those circumstances, a vendor must be able to show through documentation—in addition to the directions for use—that the device was intended to be used as a prosthetic appliance at the time of purchase, such as an exemption certificate or other certification from the purchaser.

The Department does not maintain a list of exempt or non-exempt devices. The following chart provides guidance in substantiating the prosthetic appliance deduction from TPT:

Documentation Substantiating a Prosthetic Appliance Deduction⁹	
Description of Sale	Examples of Substantiating Documentation¹⁰
Bulk sales of a prosthetic appliance to a medically licensed health care provider or other medically licensed business that will itself use the items for patient care.	<ul style="list-style-type: none"> • The invoice describing the item sold together with a properly completed Arizona Form 5000 (Transaction Privilege Tax Exemption Certificate) from the purchaser; or • Documentation that the purchaser is a licensed health care provider together with: <ul style="list-style-type: none"> ○ The invoice describing the item sold; or ○ FDA-required product labels and directions for use which show that the intended use or uses of the device are as a prosthetic appliance; or ○ Documentation that the device qualifies as a prosthetic appliance; or ○ Other documentation showing that the device will be used as a necessary part of an integrated prosthetic process or as a device necessary to apply a prosthetic appliance if the device is not normally considered a prosthetic appliance.
Bulk sales of a prosthetic appliance to a pharmacy or other retailer that will resell the item.	The invoice describing the item sold together with a properly completed Arizona Form 5000A (Arizona Resale Certificate) from the purchaser.

⁹ The vendor is responsible for analyzing whether a device being sold qualifies as an exempt prosthetic appliance. This chart provides guidance in substantiating the exemption after the vendor has already made its analysis using steps 1 through 6, discussed above.

¹⁰ Other substantiating documentation may be acceptable; this list of example documentation is not exhaustive.

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<p>Licensed health care provider selling a prosthetic appliance to a customer (hospitals, doctor's offices, outpatient facilities etc.)</p>	<p>Provided that the provider is licensed and the device is being used as part of care provided, no documentation needed.</p>
<p>Retailer selling "Rx only" [prescription only] prosthetic appliance to an individual</p>	<ul style="list-style-type: none">• The invoice describing the item sold and any of the following:<ul style="list-style-type: none">○ FDA-required product labels and directions for use which show that the intended use or uses of the device are as a prosthetic appliance; or○ Documentation that the device qualifies as a prosthetic appliance; or○ Other documentation showing that the device will be used as a necessary part of an integrated prosthetic process or as a device necessary to apply a prosthetic appliance if the device is not normally considered a prosthetic appliance.
<p>Retailer selling prosthetic appliance that was recommended by a licensed medical provider to the individual purchasing the device or to whom the individual is purchasing the device for.</p>	<ul style="list-style-type: none">• Arizona Form 5000 properly completed by the purchaser indicating the item was recommended by a licensed medical provider, or• Spreadsheet maintained by the retailer on an ongoing basis that includes the name of each purchaser purchasing a recommended prosthetic appliance, the date of sale, invoice number, a description of the prosthetic appliance sold and a statement that the retailer confirmed it was recommended by a licensed medical provider, or• A statement signed by the purchaser indicating that the appliance was recommended by a licensed medical provider and any of the following:<ul style="list-style-type: none">○ The invoice describing the item sold, or○ FDA-required product labels and directions for use which show that the intended use or uses of the device are as a prosthetic appliance, or○ Documentation that the device qualifies as a prosthetic appliance or○ Other documentation showing that the device will be used as a necessary part of an integrated prosthetic process or as a device necessary to apply a prosthetic appliance if the device is not normally considered a prosthetic appliance

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Robert Woods (Apr 7, 2023 16:03 PDT)

Robert Woods, Director

Signed: April 7, 2023

Explanatory Notice

The purpose of a tax ruling is to provide interpretive guidance to the general public and to department personnel. A tax ruling is intended to encompass issues of law not adequately covered in statute, case law or administrative rules. A tax ruling is a position statement that provides interpretation, details or supplementary information concerning the application of the law. Relevant statute, case law or administrative rules, as well as a subsequent ruling, may modify or negate any or all of the provisions of any tax ruling. See GTP 96-1 for more detailed information regarding documents issued by the Department of Revenue.