Qualified Manufacturers are No Longer Subject to Arizona Sales Tax on Purchases of Electricity and Natural Gas

This month's state and local tax (SALT) column focuses on Arizona's new transaction privilege ("sales") tax deduction for purchases of electricity and natural gas by qualified manufacturers. The deduction went into effect on August 1, 2014.

General Qualifications

To qualify for the sales tax deduction, businesses must be "principally engaged" in manufacturing, and at least 51 percent of the electricity or natural gas purchased must be used in manufacturing. The deduction does not apply to the cost of gas transportation services.

Definition of "Manufacturing"

The statute defines "manufacturing" as "the performance as a business of an integrated series of operations that places 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."

But, for purposes of the deduction, manufacturing does not include "processing, fabricating, job printing, mining, generating electricity or operating a restaurant."

What does it Mean to be "Principally Engaged" in Manufacturing?

The new statute provides that "principally engaged" in manufacturing means at least 51 percent of the business is a manufacturing operation.

According to draft guidance from the Arizona Department of Revenue, businesses that do not qualify for the deduction at the entity level may still qualify at the facility level.

ADOR's draft guidance provides that companies are principally engaged in manufacturing if 51 percent or more of their business is directly related to manufacturing based on the percentage of their: (1) capital equipment costs that are directly related to manufacturing; (2) revenue that is directly related to manufacturing; (3) head count that is directly related to manufacturing; and (4) square footage that is directly related to manufacturing. According to ADOR's draft guidance, businesses are "principally engaged" in manufacturing if they satisfy the 51 percent test for two or more of these criteria.

The Other 51 Percent Test

To qualify for the deduction, businesses that are principally engaged in manufacturing also must use at least 51 percent of the electricity that they purchase in manufacturing operations in order to qualify for the electricity deduction and at least 51 percent of the natural gas that they purchase in manufacturing operations in order to qualify for the natural gas deduction.

Some Arizona Municipalities May Not Allow the Deduction

The legislature left it up to each Arizona city and town to decide for itself whether to provide a corresponding local sales tax deduction, so we should know soon which municipalities follow the state's lead by adding this incentive for manufacturers to locate and expand their operations in Arizona to their local tax codes.

Practice Tip! – Savvy CPAs alert their clients to tax law changes that affect them. If any of your clients clearly are manufacturers, or may fall under the relatively broad language that the Arizona Legislature used to define "manufacturing" for purposes of this new deduction, they will appreciate it if you bring this potential tax savings opportunity to their attention and help them determine whether it applies to them. AZ CPA

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