

Taxing Contractors Under Arizona's Sales Tax Reform Laws

by James G. Busby Jr.



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James G. Busby Jr. is a state and local tax attorney at the Cavanagh Law Firm in Phoenix. Before entering private practice in 1999, Busby was the chief auditor in charge of transaction privilege (sales) tax audits at the Arizona Department of Revenue. He can be reached at JBusby@CavanaghLaw.com.

In this article, Busby summarizes when construction contractors are required to pay Arizona transaction privilege tax on the construction materials they purchase and when they are required to pay prime contracting tax on 65 percent of their gross receipts instead under the 2015 amendments to Arizona's sales tax laws.

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Arizona's Method of Taxing Contractors and Its Reform

Rather than pay sales tax on construction materials like contractors in most states, until January 1, 2015, all construction contractors in Arizona were instead entitled to purchase building materials tax free because they or the prime contractor they worked for were subject to Arizona's prime contracting tax on 65 percent of their gross receipts.

During the 2013 session, Arizona's then-Gov. Jan Brewer encouraged the State Legislature to simplify the taxation of contractors by repealing Arizona's prime contracting tax and, as in most other states, imposing sales tax on the building materials that contractors purchase. However, Arizona municipalities successfully lobbied against this proposal because they were concerned about its fiscal impact. In Arizona prime contracting taxes are paid to the city where the construction is performed, while retail sales taxes are paid to the city where the retailer is located.

Instead of eliminating the prime contracting tax, the Legislature passed HB 2111¹ in 2013, which resulted in a bifurcated system for contractors, with tax due on purchases of materials for some projects and prime contracting tax due

on other projects. HB 2111 was scheduled to go into effect on January 1, 2015, but last year, because of problems with the law, the Legislature repealed the provisions directly regarding the taxation of contractors and replaced them with the provisions in HB 2389.²

Major Changes and a Subsequent Amendment

Under HB 2389, beginning January 1, 2015, contractors would be required to pay sales tax on building materials for some types of projects instead of paying tax on 65 percent of their gross receipts. However, for other types of projects, contractors were allowed to continue purchasing building materials were tax free because they or the prime contractor they work for is subject to Arizona's prime contracting tax instead.

Unfortunately, HB 2389 would not resolve all of the questions the construction industry identified regarding the sales tax reforms, and many contractors were not even aware of the changes. Thus, while major changes regarding the taxation of contractors took effect January 1, many contractors and material suppliers misunderstood the new rules.

Accordingly, one of the first bills to make it through the Legislature in 2015 amended the contractor sales tax reforms for the third time in three years. As an emergency measure, SB 1446 took effect when Arizona's new governor, Doug Ducey (R), signed it on February 24, and, because SB 1446 has a retroactivity clause, it is retroactive to January 1.³ After the Legislature passed SB 1446, it amended the definition of the term "replacement" in HB 2147.⁴ When that definition takes effect July 3, 2015, it also will be retroactive to January 1.

Rather than focus on the iterative changes made by Arizona's four sales tax reform bills, this article summarizes Arizona's laws regarding the taxation of contractors as of January 1, 2015, under HB 2389, SB 1446, and HB 2147.⁵ This summary is not intended to be comprehensive. Interested parties should carefully review the relevant statutory provisions or contact a state and local tax professional for assistance.

²Laws 2014, Ch. 263.

³Laws 2015, Ch. 4.

⁴Laws 2015, Ch. 72.

⁵Except as noted below, statutory references herein are to the version of the statutes that took effect under SB 1446.

¹Laws 2013, Ch. 255.

Construction Materials Are Now Taxable When Used in MRRA Projects

The term “contractor” in this article refers to persons or companies engaged to perform construction activities involving real property, regardless of whether they are licensed by the Registrar of Contractors to perform those services or required to report sales tax as a prime contractor.⁶ However, the term “prime contractor” refers specifically to persons or companies that should be licensed by Arizona’s taxing authorities to report sales tax on projects that are subject to Arizona’s state and local prime contracting taxes.

Contractors are subject to tax on tangible personal property incorporated or fabricated into projects in Arizona involving the maintenance, repair, replacement, or alteration (MRRA) of real property or existing real property improvements, if their contract does not involve more than a de minimis amount of “modification” activity. Proceeds from MRRA projects are not subject to prime contracting tax.

Except as described below in the section regarding change orders, each contract is evaluated independently to determine whether a project is taxable as an MRRA project or as a prime contracting project. So a contractor may be responsible for paying tax on materials for MRRA projects and, at the same time, be responsible for tax as a prime contractor for other projects.

The De Minimis Test

The Legislature did not define de minimis, but according to ADORTPN 15-1, a “modification activity included in an MRRA contract will be considered ‘de minimis’ if the amount attributable to the modification is 15 percent or less of the total receipts from the total contract.”⁷ Proceeds from modification activities, as that term is defined below, are what trigger the prime contracting tax on contractors, or the prime contractor for whom they work. So under the de minimis test, proceeds from projects that involve MRRA activities are subject to prime contracting tax if 15 percent or more of the proceeds from the project are for modification activities.

MRRA Definitions

The Legislature did not define maintenance, but according to ADOR TPN 15-1, “‘maintenance’ is the upkeep of property or equipment. Examples of maintenance include an annual HVAC system checkup that includes topping off any fluids, restaining a wood deck, and refinishing hardwood floors.” Likewise, the Legislature did not define the term “repair,” but according to ADOR TPN 15-1, “‘repair’ is an activity that returns real property to a usable state from a partial or total state of inoperability or nonfunctionality.”⁸ Examples of repairs include “recharging partially or totally nonfunctional air-conditioning units with refrigerant, fix-

ing a leak from a bathtub or shower, clearing partially or completely blocked pipes of debris, readjusting satellite dishes to restore reception, and replacing worn washers in leaky or totally inoperable faucets.”⁹

The Legislature defined “replacement” in HB 2147 as:

the removal from service of one component or system of existing property or tangible personal property installed in existing property, including machinery or equipment, and the installation of a new component or system or new tangible personal property, including machinery or equipment, that provides similar or an upgraded design or functionality, regardless of the contract amount and regardless of whether the existing component or system or existing tangible personal property is physically removed from the existing property.¹⁰

The Legislature defined alteration as “an activity or action that causes a direct physical change to existing property” but imposed limitations on the size of projects that qualify as alteration projects. Proceeds from projects that exceed the scope of these limitations are taxed as prime contracting projects rather than as MRRA projects. The Legislature also specifically provided that alteration activities do not include “maintenance, repair or replacement” activities.¹¹

The Limit on the Size of Residential Alteration Projects

Projects involving properties classified as residential properties for property tax purposes — including some properties owned by specific types of nonprofit companies — exceeding 25 percent of the most recent full cash value of the property established by the county assessor as of the date of the bid or the date of the contract, are not alteration projects and must be taxed as prime contracting projects rather than as MRRA projects.¹² Contractors are prohibited from artificially separating projects into multiple parts to avoid treating them as prime contracting projects. However, there is a safe harbor for projects that the owner and contractor reasonably believed would be alteration projects at the inception of the contract if they do not exceed the 25 percent test by more than 25 percent (for a total of 31.25 percent of the full cash value of the property).

The Limits on the Size of Other Alteration Projects

Projects involving other types of properties are not alteration projects and must be taxed as prime contracting projects rather than as MRRA projects if: (1) the contract is for

⁶A.R.S. section 42-5075(O).

⁷Ariz. DOR TPN 15-1, at 1, A2.

⁸*Id.*

⁹*Id.*

¹⁰A.R.S. section 42-5075(R)(11) as amended by HB 2147, which will be retroactive to January 1, 2015 when it becomes effective on July 3, 2015.

¹¹A.R.S. section 42-5075(R)(1).

¹²A.R.S. section 42-5075(R)(1)(b), (c), and (d).

more than \$750,000 (\$937,500 with the safe harbor); (2) the scope of the work directly involves more than 40 percent of the existing square footage of the existing property (50 percent with the safe harbor); or (3) the scope of the work involves expanding the square footage of the existing property by more than 10 percent (12.5 percent with the safe harbor). For tenant improvements, the Department of Revenue's interpretation of parts (2) and (3) is that the percentages are calculated based only on the portion of the building that the tenant controls.

Here again, contractors are prohibited from artificially separating projects into multiple parts to avoid treating them as prime contracting projects. However, there is a safe harbor for projects the owner and contractor reasonably believed would be alteration projects at the inception of the contract if they do not exceed any of the applicable tests by more than 25 percent.

Calculating the Tax on Materials Used in MRRA Projects

For tangible personal property incorporated into MRRA projects, unless the property qualifies for an exemption, contractors must either pay sales tax to their Arizona vendors when purchased, or pay an amount equal to tax directly to the DOR and, in some cases, to a city or town, in the reporting period that includes the month during which the property was incorporated into the project.¹³ Delinquent payments may be subject to penalties and interest.

Contractors that opt to pay sales tax to Arizona vendors of tangible personal property will pay tax at the rate that applies when purchased at the permanent business location of the vendor where the vendor received the order. Contractors that purchase tangible personal property tax free but then use it in an MRRA project are subject to an amount equal to the tax a vendor would have been required to pay. That amount is due in the reporting period that includes the month during which the property was incorporated into the project, and the tax rate that applies is the effective rate where the project is located. Special inventory rules apply to contractors that purchased building materials tax free but later cancel their prime contracting sales tax license.

Offsetting Prime Contracting Tax Liabilities

As explained above, contractors purchasing materials for MRRA projects may either pay sales tax to the vendors at the time of purchase or pay an amount equal to the tax directly to state taxing authorities.¹⁴ However, only amounts paid directly to taxing authorities may be used to offset a prime contracting tax liability in situations when the taxing au-

thority later determines that the project should have been taxed as a prime contracting project instead of as an MRRA project.

Accordingly, the DOR plans to modify Arizona Form 5005 so that contractors responsible for an MRRA project can give one to any subcontractors on the project to direct them not to pay tax on materials when they purchase them because the contractor responsible for the MRRA project will instead pay an amount equal to the tax directly to Arizona taxing authorities for all materials used in the MRRA project.

Publicly Funded Road Projects Are Not Subject to MRRA Rules

The analysis described above regarding MRRA projects does not apply to projects primarily involving surface or subsurface improvements to land (such as roads) that are subject to public procurement rules.¹⁵ Rather, such publicly funded road-related projects are specifically taxable as prime contracting projects in the manner outlined below. However, not all publicly funded road projects are taxable as prime contracting projects, and not all privately funded road projects are taxable as MRRA projects. Rather, most Arizona Department of Transportation road projects are taxable as prime contracting projects, and most projects for special taxing districts, and all projects for private parties, are subject to the MRRA analysis to determine whether they are taxable as MRRA projects or as prime contracting projects.

When Contractors Are Required to Pay Prime Contracting Tax

When 15 percent or more of a contractor's proceeds from a particular project are for modification activities rather than for MRRA activities, the prime contractor's proceeds from that project are subject to prime contracting tax, and the contractors working on the project may purchase tangible personal property to be incorporated or fabricated into that project tax free.¹⁶

Prime contracting tax applies to 65 percent of prime contractors' gross receipts, after allowable exemptions and deductions, at the tax rate in effect when the construction activities are performed. Prime contractor is still defined as:

a contractor who supervises, performs or coordinates the modification of any building, highway, road, railroad, excavation, manufactured building or other structure, project, development or improvement including the contracting, if any, with any subcontractors or specialty contractors and who is responsible for the completion of the contract.¹⁷

¹³A.R.S. section 42-5008.01.

¹⁴A.R.S. section 42-5008.01(D).

¹⁵A.R.S. section 42-5075(P).

¹⁶A.R.S. section 42-5075.

¹⁷A.R.S. section 42-5075(R)(10).

Subcontractors on prime contracting projects who can prove both that they were working for a prime contractor on a particular job and that the prime contractor was liable for tax on the proceeds from which the subcontractor was paid are not subject to prime contracting tax on that job. The best way for a subcontractor to prove that it is not subject to prime contracting tax on a particular job is to obtain a completed copy of Arizona Form 5005 from the prime contractor.

The New Definition of Modification

The Legislature amended the definition of modification to mean “construction, grading and leveling ground, wreckage or demolition.” And the Legislature specifically provided that modification does not include any:

- MRRA project;
- wreckage or demolition of existing property, or any other activity that is a necessary component of an MRRA project; and
- mobilization or demobilization regarding an MRRA project, such as the erection or removal of temporary facilities to be used by contractors working on the project.¹⁸

How Change Orders Are Taxed

While contractors normally must evaluate each contract independently to determine whether it is an MRRA project or a prime contracting project, special rules apply for change orders. Any change order that directly concerns the scope of work of the original contract must be treated the same as the original contract, regardless of the amount of modification activities in the change order.¹⁹ However, for change orders that do not directly concern the scope of work of the original contract, the change order is treated as a new contract and must be independently evaluated to determine whether it is an MRRA project or a prime contracting project.

Subsequent change orders follow the tax treatment of the contract or change order to which the scope of work of the subsequent change order directly relates. And if a subsequent change order does not directly concern the scope of work of an existing contract or change order, it too must be evaluated independently. The treatment of change orders outlined above does not alter or affect the treatment of change orders for other purposes, including the application of new tax rates to change orders.

A Host of Exemptions

Contractors may purchase and pass along the cost of tangible personal property without tax when it is incorporated or fabricated into a project for a qualifying hospital or healthcare organization, whether they are engaged in a

prime contracting project or an MRRA project.²⁰ Qualifying hospitals and healthcare organizations must obtain letters from the DOR every year stating that they qualify for these exemptions, and contractors that work for them should retain a copy of those letters.

Although the DOR does not issue annual letters to them, the same rules apply to projects located on Indian reservations for Indian tribes and Native Americans who are registered members of the tribe.²¹

Contractors also may purchase and pass along the cost of qualifying machinery, equipment, and other tangible personal property without tax when it is incorporated or fabricated into a project for a manufacturer, processor, job printer, utility company, telecommunications company, mine, or other qualifying business, whether the contractor is engaged in a prime contracting project or an MRRA project.²² To document the exemptions referred to in this section, contractors should obtain a copy of Arizona Form 5000 from their customer claiming the relevant exemption, give a copy to their vendors, and retain a copy for their files.

Exemption Certificates for Building Materials

Contractors and their subcontractors working on a project that is subject to prime contracting tax may purchase tangible personal property that will be incorporated or fabricated into real property as part of the project tax free.²³ Prime contractors and their subcontractors working on an MRRA project also have the option of purchasing tangible personal property that will be incorporated or fabricated into an MRRA project tax free.²⁴ However, as described above, ultimately those materials are subject to tax, unless an exemption applies.²⁵

Contractors, including subcontractors, licensed as prime contractors with the DOR for sales tax purposes should use Arizona Form 5000 to purchase building materials tax free from Arizona vendors. Subcontractors not licensed as prime contractors for sales tax purposes are not permitted to purchase building materials tax free unless they obtain an Arizona Form 5009L from the prime contractor they are working for.²⁶ These certificates are only good for a specific project and must be approved by the DOR before they are valid.

Tax Licenses, Registrar of Contractor Licenses, and Building Permits

Contractors that only work on MRRA projects, or that only work as subcontractors on prime contracting projects,

¹⁸A.R.S. section 42-5075(R)(6).

¹⁹A.R.S. section 42-5075(O)(2).

²⁰A.R.S. sections 42-5061(A)(25) and 42-5075(B)(8)(a).

²¹A.R.S. section 42-5061(A)(60).

²²A.R.S. sections 42-5008.01(A)(2) and (3) and 42-5075(B)(8).

²³A.R.S. section 42-5061(A)(27).

²⁴*Id.*

²⁵A.R.S. section 42-5008.01.

²⁶A.R.S. section 42-5009(L).

are not required to maintain their sales tax license if they already have one or to obtain a sales tax license if they are just going into business.²⁷ However, subcontractors without sales tax licenses working for prime contractors on prime contracting jobs are unable to purchase building materials for those jobs tax free unless they obtain a copy of Arizona Form 5009L from the prime contractor they are working for on a particular project.²⁸

Arizona's Registrar of Contractors may no longer require contractors to provide a sales tax license number when applying for or renewing a contractor's license. Cities, towns, and counties may not require an applicant for a building permit to hold a sales tax license or a business license as a condition for issuing the permit. However, cities and towns may require a contractor that has a building permit but lacks a business license from the city or town to apply for a business license within 30 days of issuing the permit.²⁹

Inventory Rules for Contractors That Cancel Sales Tax Licenses

Contractors that purchased tangible personal property tax free because it was to be incorporated into a taxable prime contracting project but that later cancel their sales tax license and use, consume, or sell the property are liable for tax on those items.³⁰ The amount due must be reported on or before the business day preceding the last business day of the month following the month the contractor uses the property in a taxable manner described below. Otherwise, penalties and interest may apply.

If such property is used in an MRRA project or otherwise used or consumed, unless an exemption, deduction, or exclusion applies, tax is due based on the purchase price of the property at the rate in effect where the property was used or consumed. However, if the contractor that hired a subcontractor with such property provided the subcontractor with a certificate stating that the contractor is liable for tax or other amounts due on that property, the subcontractor is not liable for tax or other amounts due unless the subcontractor had reason to believe the certificate was erroneous or incomplete. Rather, in those situations, the contractor that provided the certificate is liable for the tax or other amount due. If the property is sold, the amount due is based on the amount of the payment received by the contractor at the rate in effect at the contractor's principal place of business in Arizona. If the property is discarded and the contractor receives no payment of any kind, no sales tax is due.

Special Inventory Rules for Contractors That Canceled Their Sales Tax License Before May 1, 2015

The following one-time special rules apply to contractors that canceled their sales tax license before May 1, 2015, and have an inventory of materials purchased tax free because they were intended to be incorporated into a construction project.³¹

As long as such contractors had no intent to evade taxation, they may make a reasonable estimation of the value of their inventory on hand when they canceled their license, and if the estimate of value is \$10,000 or less, the contractor is not liable for any tax that otherwise would be due. If the estimate of value is more than \$10,000, the first \$10,000 is not subject to tax and the contractor may opt to report tax on the remainder (a) in the manner outlined in the previous section; (b) in a single payment based on the tax rate in effect at the contractor's principal place of business; or (c) in 12 equal monthly installments beginning immediately following the month in which the contractor's sales tax license is canceled based on the tax rate in effect at the contractor's principal place of business.

Safe Harbors for Contracts Bid Before May 1, 2015

For contracts or other binding obligations bid or entered into before May 1, 2015, contractors (1) may, at their option, treat proceeds from the contract as a project that is taxable under the prime contracting classification, and (2) will be held harmless from any additional tax, penalty, or interest if the DOR later determines that the contractor's good-faith treatment of the project, either as a prime contracting project or an MRRA project, was incorrect.³²

What's Next for Arizona Contractors?

Recognizing that it fell short of its goal to "simplify the administration of Arizona's transaction privilege tax in order to alleviate taxpayer confusion, [and] relieve businesses from unnecessary compliance costs,"³³ the 2015 Legislature stated that the purpose of SB 1446 is "to clarify and simplify the transaction privilege tax reform measures [previously enacted] until such time as the prime contracting classification can be repealed."³⁴

Hopefully there will soon be enough votes in the Legislature to repeal Arizona's now-more-complicated-than-ever method of taxing contractors and replace it with a pure tax on materials as in most other states. ☆

²⁷A.R.S. sections 9-467 and 11-321(B).

²⁸A.R.S. section 42-5009(L).

²⁹A.R.S. section 42-467(B).

³⁰A.R.S. section 42-5008.01(B).

³¹SB 1446 — Laws 2015, Ch. 4, Sec. 16(B).

³²SB 1446 — Laws 2015, Ch. 4, Sec. 16(C).

³³HB 2111 — Laws, 2013, Ch. 255, Sec. 27.

³⁴SB 1446 — Laws 2015, Ch. 4, Sec. 14.