

Southwest Business Credit Services

Transaction Privilege Tax: What You Need to Know

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Background—Why Are We Here?

- 2013 & 2014: Governor Brewer signs legislation reforming the TPT (Sales Tax) system
 - Goal: simplify Arizona's TPT system, which was the most complex in the US
 - Construction industry pushed for repeal of the prime contracting classification
 - Cities and towns balked
 - Compromise: hybrid tax structure, with some projects taxable as prime contracting, and other projects not taxable as prime contracting
- 2015-2019: Arizona Department of Revenue implements the new TPT system
 - 2015: Legislation fixed problems initially encountered by the construction industry
 - TPN 15-1 provides administrative guidance that clarifies outstanding issues
 - 2016: ADOR revises exemption forms and introduces additional exemption forms
 - 2017: ADOR's website for reporting and paying TPT, aztaxes.gov, debuts and is now in use
 - 2019-2021: Mandatory electronic filing and payment

How Does The TPT System Work?

Simplified Reporting and Payment of Transaction Privilege Tax (Sales Tax)

- TPT collection and administration centralized with ADOR
 - **Licensing:** ADOR issues all TPT licenses, including all municipal licenses
 - All licenses must be renewed annually on a calendar year basis
 - TPT license no longer required to obtain a contractor's license or a building permit
 - Reason: contractors who work on only MRRA projects need not obtain a TPT license
 - **Reporting:** Businesses file one TPT return with ADOR each month
 - No more municipal TPT returns
 - ADOR distributes TPT collections to municipalities
 - **Auditing:** Businesses subject to one audit by ADOR for tax on all levels
 - No more municipal TPT audits
 - Exception: a municipality may still audit companies that do business in only that municipality
- As of January 1, 2017, online reporting and payment of TPT is in effect for ALL cities
 - Distinction between "program cities" and non-program cities no longer applies
 - Use aztaxes.gov to report and pay tax
 - Use Form TPT-2 to report and pay tax
 - Form TPT-1 is no longer accepted for reporting periods after June 1, 2016!
- Transition to electronic reporting and payment
 - As of January 1, 2021: Businesses with annual TPT liability of \$500.00 or more must file and pay electronically or be subject to penalties
 - Penalty for filing a paper return is equal to 5% of the amount due, with a minimum of \$25
 - Penalty for paying by check is 5% of the amount of the payment made by check
 - ADOR may send notices, including deficiencies and assessments, electronically and by e-mail
 - CAUTION: ensure that your email address on file with ADOR is current!

All Construction Projects Are Not Taxed Equally

- Before January 1, 2015: all contracting activity was taxable prime contracting
 - Contractors paid prime contracting TPT on 65% of their gross receipts
 - Subcontractors were exempt from paying prime contracting TPT
 - Sales of materials to contractors and subcontractors were not subject to retail TPT
- Today: construction activity is taxable prime contracting UNLESS it qualifies as an MRRA project (sometimes known as "service contracting")
 - Prime contracting projects are taxed under the old regime
 - MRRA projects are exempt from prime contracting TPT, but contractors report and pay an amount equal to retail TPT on materials used
- What is the prime contracting TPT classification?
 - A.R.S. § 42-5075: “The prime contracting [TPT] classification is comprised of the business of prime contracting and dealership of manufactured buildings.”
 - “Prime contracting” means “engaging in business as a prime contractor.”
 - Prime contractor: a person who “performs, coordinates, or supervises modification work, including contracting with any subcontractors”
 - “Modification” is defined very broadly: as construction, wreckage, demolition activity, or “grading and leveling ground”
 - Does NOT include any wreckage or demolition of “existing property”
 - Does NOT include “any activity” that is a “necessary component” of an MRRA project
- What is an MRRA project?
 - A project qualifies for an exemption as an MRRA project if:
 - The construction contract is between the owner and the contractor AND
 - The project is for the maintenance, repair, replacement, or alteration of existing property
 - Maintenance: “the upkeep of property or equipment”
 - Ex: restaining a wood deck, or refinishing a hardwood floor
 - Repair: activity that “returns real property to a usable state from a partial or total state of inoperability or nonfunctionality,”
 - Ex: clearing a blocked pipe or replacing a worn washer in a leaky faucet
 - Replacement: the “removal of one component or system of existing property . . . and the installation of a new component or system . . . that provides the same or upgraded design or functionality”
 - Ex: replacing HVAC system or a tile roof
 - Legislative clarification: replacement classification applies whether or not the existing component or system is physically removed from the property
 - Ask yourself: is the old system being taken out of service?

- Alteration: an activity that “causes a direct physical change to existing property” AND meets one of the following tests:
 - Residential Property: Project is an alteration if the contract price is 25% or less of the property’s Full Cash Value
 - All Other Property:
 - Contracts entered into after January 1, 2019: Project is an alteration if the contract price is \$750,000 or less
 - Square footage calculations no longer apply!
 - Contracts entered into before January 1, 2019: Project is an alteration if ALL of the following are true:
 - Contract price is \$750,000 or less
 - Scope of work directly relates to 40% or less of existing square footage
 - Scope of work includes expansion of square footage that is 10% or less of existing square footage
 - If project qualifies as alteration when work begins, the project continues to qualify even if the relevant threshold is exceeded by no more than 25%
 - The 25% “cushion” is calculated based on the statutory threshold (e.g. \$750,000 x 25%), not based on the project’s numbers
 - CAUTION: an alteration always involves existing property
 - New construction is always taxable prime contracting, regardless of the price
 - CAUTION: a contractor may not make a project an “alteration” by “artificially separating” elements of a project to make the project qualify
 - What does “artificially separating” mean? Unknown.
- “Owner” includes agents of the owner
 - Examples: tenant, property manager, subcontractor who works for the general contractor retained by the owner
- Who receives the tax revenue?
 - Prime contracting projects: The State and the place of the project
 - MRRA projects: That depends . . .
 - Contractors with a TPT license: The State and the place of the project
 - Contractors without a TPT license: Pay retail TPT on materials at the point of sale, unless materials are purchased tax free under Form 5000M
- What if a project consists of both modification activity and maintenance, repair or replacement activity?
 - Rule: unless the project meets the “de minimis test,” the entire contract is taxable prime contracting
 - What is the threshold for the de minimis test? 15% of the contract price
 - If modification activity is less than 15% of the total contract price, the entire project is classified as an MRRA project
 - If modification activity is 15% or more of the total contract price, the entire project is classified as prime contracting

- What about change orders?
 - If change order work directly relates to the original contract work, tax treatment will remain consistent
 - Example: original contract is for a new roof on an existing home (replacement) and change order is for a new roof on a separate structure (also a replacement)
 - If change order work is not related to the original scope, tax treatment of change order work is determined independently
 - Effect: taxed as a separate contract
 - Example: original contract is for a new roof on an existing home (replacement) and change order is for constructing a new detached garage (prime contracting)

Exemption Certificates and Materials Purchases

- Types of Exemption Certificates
 - Form 5000: used by licensed contractors or subcontractors to purchase materials for prime contracting and MRRA projects free of retail TPT
 - Certificate valid for up to 48 months but only if TPT license is renewed annually
 - Form 5000A: used to purchase goods for resale free of retail TPT
 - Certificate valid for up to 48 months but only if TPT license is renewed annually
 - Form 5000HC: used by qualified health care entities to purchase goods free of retail TPT
 - Form 5000M: used by non-licensed contractors to purchase materials for MRRA projects that are statutorily exempt from TPT
 - Ex: data centers, projects on Indian reservations, charitable organizations
 - Certificate valid for only up to 12 months
 - Form 5005: used by a licensed general contractor to establish liability for remitting TPT
- Contractors and subcontractors may buy materials free of retail TPT using Forms 5000, 5000A, 5000HC or 5000M
 - CAUTION: exemption certificates are valid for up to 48 months, but TPT licenses must be renewed each calendar year
 - A supplier may only sell materials free of retail TPT if the customer holds a current TPT license, regardless of whether the customer’s exemption certificate is current on its face!
 - DO NOT rely upon only the exemption form to sell materials free of retail TPT!
 - Verify that the customer holds a current TPT license each calendar year
 - TPT license verification: <https://www.aztaxes.gov/Home/LicenseVerification>
 - Keep detailed records!
 - CAUTION: contractors and subcontractors who purchase materials for inventory free of retail TPT must carefully track the use of the materials
 - Materials used in MRRA projects are subject to retail TPT
 - Keep detailed records!
 - CAUTION: for MRRA projects, contractors and subcontractors who buy materials free of retail TPT must pay “amount equal to retail TPT” to the city in which the project is located, NOT the city where materials are purchased
 - Tax is due when the materials are incorporated into the project

- “Carrot and stick” approach to Form 5005: General contractors may issue blanket Form 5005 to licensed subcontractors for all projects, not just taxable prime contracting projects
 - Issuing Form 5005 permits subs to buy materials tax free under their Form 5000
 - Avoids risk of subs paying retail TPT on materials without reimbursement by the GC
 - “Carrot and stick” approach encourages use of Form 5005 on MRRA projects
 - Stick: general contractor pays retail TPT on materials used by subs in MRRA projects
 - CAUTION: subs **MUST** report to the general contractor the cost of materials that are not taxed at the point of sale
 - If a sub does not want to divulge its costs, the sub should assume responsibility for paying the tax!
 - Carrot: if ADOR later reclassifies a project from MRRA to taxable prime contracting, the general contractor may offset the retail TPT it paid on behalf of subcontractors against any liability for prime contracting tax
 - Contractor that does not issue Form 5005 cannot claim this offset
 - Eliminates risk of double taxation!
 - Subcontracts should clearly specify who remits TPT and the subcontractor's reporting obligations
- What if a subcontractor on a taxable prime contracting project *does not* hold a TPT license?
 - An unlicensed subcontractor ordinarily cannot purchase materials free of TPT
 - Form 5000 may not be used under any circumstances!
 - Solution: the general contractor must obtain an executed Form 5009-L from ADOR
 - Subcontractor can then present the Form 5009-L to suppliers and purchase materials tax free
 - Form 5009-L issued on a project-by-project basis and must be issued in advance by ADOR

Recent Developments at ADOR

- TPP 20-1: COVID-19 Penalty Abatement (Issued July 14, 2020)
 - Impacts of COVID-19 and subsequent shutdown orders are deemed a reasonable basis for failure to timely file TPT returns and pay TPT
 - Applies to taxable periods beginning 3/1/2020 and continuing until further notice
 - TPP 20-1 sets forth the process for requesting penalty abatement
- GTN 20-3: ADOR is accepting scanned and digital signatures temporarily due to COVID-19 impacts
 - Watch for updates! Follow the most current guidance.

What does your business need to do?

Everybody: Keep detailed records! Watch for changes to the law!

General Contractors

- Every year: Renew all TPT licenses AND submit new exemption forms to vendors
- Classify projects as prime contracting or MRRA projects
 - Set forth the classification in the construction contract
- Buy your materials free of retail TPT using Form 5000
 - CAUTION: track whether inventory is used in prime contracting or an MRRA project
- For MRRA projects, decide whether you want to assume responsibility for remitting an amount equal to retail TPT for materials used by your subcontractors
 - If so, issue a Form 5005 to your subcontractors
 - Change your subcontract to require subs to report the cost of materials purchased
- Avoid headaches caused by Form 5009-L
 - Current projects: verify that your subcontractors hold TPT licenses
 - Future projects: consider requiring your subcontractors to hold TPT licenses
 - Alternative: change your form subcontract to prohibit unlicensed subcontractors from billing for retail TPT, as cost of the work or otherwise

Subcontractors

- Every year: Renew all TPT licenses AND submit new exemption forms to vendors
- Verify that your sub-subcontractors hold TPT licenses
- Buy your materials free of retail TPT using Form 5000
 - CAUTION: track whether inventory is used in prime contracting or an MRRA project
- For MRRA projects, decide whether you want the general contractor to assume responsibility for remitting an amount equal to the retail TPT for materials you use
 - If so, revise your subcontract: require the general contractor to issue a Form 5005
 - If not, you must report and pay the retail TPT yourself!
 - Two options: (1) pay retail TPT at point of sale or (2) purchase tax free at point of sale and report/pay retail TPT on your TPT-2
- For prime contracting projects, require the general contractor to issue a Form 5005
 - Otherwise, you may owe prime contracting TPT!
- Continue filing tax returns even if all your activities are taxable to the general contractor!
 - Show your income, with a corresponding deduction

Suppliers and Vendors

- Collect retail TPT unless the purchaser submits an executed exemption form (Forms 5000, 5000A, 5000HC, 5000M or 5009-L) and holds a current TPT license
 - Verify that the license number listed on the exemption form is valid and current!
 - ADOR verification link: <https://www.aztaxes.gov/Home/LicenseVerification>
 - Do not sell materials free of retail tax unless the customer has a current TPT license!
 - Verify that the exemption form is current!
 - Do not sell materials free of retail tax if the exemption form is expired!