

## Legal Alert

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### CONSTRUCTION TRANSACTIONS PRIVILEGE TAX UPDATE

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As you are likely aware, Arizona's transactions privilege tax ("TPT") system changed on January 1, 2015. The new TPT rules caused a number of issues for the construction industry, prompting the Legislature to pass a second bill to fix the most problematic aspects of the new system. Governor Ducey signed that bill into law on February 25, and the new law took effect immediately.

For the past several months, the Arizona Department of Revenue ("ADOR") has been working with industry groups to refine the TPT rules. In June, the agency issued new exemption forms and additional guidance.

The following discussion sets forth the principal changes to the TPT system:

#### **All Projects Are No Longer Taxed Equally**

Before January 1, 2015, virtually all construction activity was classified as prime contracting, with contractors paying TPT on 65% of their gross receipts from construction activities and purchasing materials free of retail TPT. The new law, however, distinguishes between two types of projects: prime contracting projects and service contracting projects.

Prime contracting is defined as a "modification" activity performed by a contractor on any building or property. The Legislature defined "modification" very broadly: as any construction, wreckage, or demolition activity. A project qualifies for the service contracting exemption, however, if (1) the construction contract is between the owner and the contractor and (2) the project is for the maintenance, repair, replacement, or alteration of existing property.

Prime contracting projects are taxed as they were before January 1: contractors pay prime contracting TPT instead of retail TPT on materials incorporated into the project. Service contracting projects are exempt from prime contracting TPT—contractors instead pay an "amount equal to retail TPT" on materials used in service contracting projects. This tax is paid to

the city where the project is located, not the city where the materials are purchased.

### **What is a Service Contracting Project?**

Again, a project qualifies for the service contracting exemption if (1) the construction contract is between the owner and the contractor and (2) the project is for the maintenance, repair, replacement, or alteration of existing property. For this purpose, the term “owner” also includes a management agent or a lessee.

An “alteration” is an “activity or action that causes a direct physical change to existing property.” To qualify as an alteration, the project must meet certain statutory thresholds. For residential property, a project is an alteration if the contract price is 25% or less of the property’s full cash value, as computed by the county assessor. For commercial property, a project is an alteration if (1) the contract price is \$750,000 or less, (2) the scope of work directly relates to 40% or less of existing square footage, and (3) the scope of work expands the existing square footage that is 10% or less of the pre-existing square footage.

Recently, ADOR provided additional guidance on how to calculate “existing square footage” in the context of leased property. If a construction contract is with the owner of a building, the “existing square footage” consists of the entire building. If a construction contract is with a tenant, the “existing square footage” consists of only the space leased by the tenant. This means that the taxation of certain projects will depend entirely on the identity of the contracting party.

If a project qualified as an alteration at the outset, it will continue to qualify as an alteration so long as the statutory thresholds are not exceeded by 25% by cost overruns or change orders. This 25% “buffer” means, for example, that a commercial project with a final contract price of up to \$937,500 will continue to qualify as an alteration.

The thresholds above apply *only* to alteration activities, not to maintenance, repair, or replacement activities. ADOR has defined these activities as follows:

- “Maintenance” is “the upkeep of property or equipment,” such as restraining a wood deck or refinishing a hardwood floor.
- A “repair” activity “returns real property to a usable state from a partial or total state of inoperability or nonfunctionality,” such as clearing a blocked pipe, replacing a worn washer in a leaky faucet, or readjusting a satellite dish.

- A “replacement” activity is the “removal from service of one component or system of existing property . . . and the installation of a new component or system . . . that provides the same, similar or upgraded design or functionality.”

What if a project includes some modification activity (new construction) and some maintenance, repair, or replacement activity? According to ADOR’s guidance, a project that includes a “de minimis” amount of modification activity will not be taxable prime contracting. ADOR’s guidance defines “de minimis” as 15%—that is, if modification activity is less than 15% of the total contract price, the *entire project* will fall within the service contracting exemption. If more than 15% of the contract price is for modification activity, *the entire project* will be treated as taxable prime contracting.

### **Simplified Licensing and Reporting**

Before January 2015, all contractors had to obtain a TPT license. Under the new law, however, only contractors who engage in prime contracting must obtain and hold a TPT license. Contractors who work exclusively on service contracting projects need not obtain a TPT license, even for the purpose of obtaining a building permit or a contracting license from the Registrar of Contractors.

The new law also centralizes TPT collection and administration at ADOR on January 1, 2016. At that time, ADOR will issue all TPT licenses, for the state and for all municipalities, as well as handle all license renewals (all TPT licenses must now be renewed annually by January 1 of each year). Contractors will file one TPT return with ADOR monthly that sets forth all tax owed to the state and all municipalities, and make a single payment to ADOR. Municipalities will no longer issue their own TPT licenses or collect their own taxes.

Additionally, businesses will, in most cases, be subject to a single audit by ADOR for all state, county, and municipal taxes. A municipality may audit only those companies that do business exclusively in that municipality.

The current method for reporting and paying TPT will remain in effect through 2015. You should therefore continue preparing and filing separate municipal tax returns and remitting TPT directly to municipalities, as may be required, until ADOR instructs otherwise.

### **New Exemption Forms**

Contractors may continue to purchase materials free of retail TPT using a

blanket Form 5000, but only if they hold a current TPT license. As before, general contractors should issue Form 5005, whether blanket or project specific, to subcontractors performing work on prime contracting projects—but only if those subcontractors hold a current TPT license.

General contractors should also consider issuing Form 5005 to licensed subcontractors who perform work on service contracting projects. This will make the general contractor responsible for remitting retail TPT on materials purchased by its subcontractors (which, in turn, requires subcontractors to report the cost of the materials purchased to the general contractor). The law, however, gives general contractors an incentive to take on the burden of remitting retail TPT. If, during an audit, ADOR reclassifies a service contracting project as taxable prime contracting, the general contractor may subtract the retail TPT it paid on materials used by subcontractors from its liability for prime contracting TPT, but only if the general contractor has issued Form 5005 to its subcontractors. General contractors who do not issue Form 5005 may not claim this offset.

In June, ADOR issued a new template Form 5005. General contractors should issue this form as needed on both new and existing projects. We also expect ADOR to issue a new template Form 5000 in the coming weeks—once that occurs, contractors and subcontractors who hold TPT licenses should complete and issue the new form to all suppliers.

If a contractor retains a subcontractor that does not hold a TPT license, the unlicensed subcontractor may not purchase materials free of retail TPT unless ADOR has first issued a Form 5009-L exemption certificate. The contractor must obtain a separate Form 5009-L for each project on which an unlicensed subcontractor will perform work—no blanket certificates will be issued. An owner who wants to avoid this potentially burdensome requirement should require its subcontractors to hold current TPT licenses.

### **Recommendations**

The new TPT rules affect everyone involved in construction. We recommend that owners, contractors, subcontractors and suppliers take the following actions:

#### **Owners:**

- For prime contracting projects, ensure that the general contractor holds current TPT licenses, both state and municipal.
- The construction contract should preferably specify whether the project is prime contracting or service contracting and the resulting procedures for calculating TPT.

- Monitor payment applications and backup documentation to ensure that the general contractor is charging tax correctly (e.g., charging retail TPT on materials for a service contracting project) and not charging double tax (e.g., charging prime contracting TPT and seeking reimbursement for retail TPT paid on materials).

#### Contractors & Subcontractors:

- If you perform work on prime contracting projects, renew all prime contracting TPT licenses, state and municipal, both now and annually.
- For current prime contracting projects, verify that all subcontractors and/or sub-subcontractors hold current prime contracting TPT licenses.
- For future prime contracting projects, confirm that subcontract agreements: (1) require subcontractors and sub-subcontractors to hold current prime contracting TPT licenses for the duration of a project (note that a Form 5009-L could be used on a project specific basis, but this could be administratively burdensome); and (2) do not permit subcontractors to be reimbursed for retail TPT paid for materials.
- For all prime contracting projects, contractors who hire a subcontractor or sub-subcontractor without a TPT license must submit a Form 5009-L exemption certificate to ADOR for each project on which the unlicensed subcontractor is performing work.
- Contractors should submit an updated Form 5005 to subcontractors who hold current TPT licenses for all current and future projects. Subcontractors who are working on prime contracting projects should require the general contractor to issue an updated Form 5005.
- Subcontractors should continue to file TPT returns even if all activities are taxable to the general contractor—ADOR still requires informational returns.

#### Materials Suppliers:

- Collect and remit retail TPT on all sales unless the purchaser submits a complete and current Form 5000 or 5009-L.
- Verify the validity of the TPT license number listed on the Form

5000 by checking ADOR's online database. Retain both the Form 5000 and printouts from ADOR's database for your records in the event of an audit.

### **What Does the Future Hold?**

The law governing TPT will continue to evolve. In the near term, ADOR will continue to issue guidance on the new system.

We will keep you posted on further developments as they occur. Please contact us if you have specific questions about how the new TPT system affects you or your business.

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