

**INSTALLATION OF EXEMPT MACHINERY  
AND EQUIPMENT:**

**When Is It Taxable Contracting And  
Would Someone Please Define “Permanent Attachment”**

- **PURCHASE AGENCY NO LONGER NEEDED FOR  
EXEMPT MACHINERY AND EQUIPMENT**
- **INSTALLATION LABOR IS EXEMPT IF EXEMPT  
MACHINERY AND EQUIPMENT IS NOT  
PERMANENTLY INSTALLED**
- **DEPARTMENT USES THE *ARIZONA OUTDOOR  
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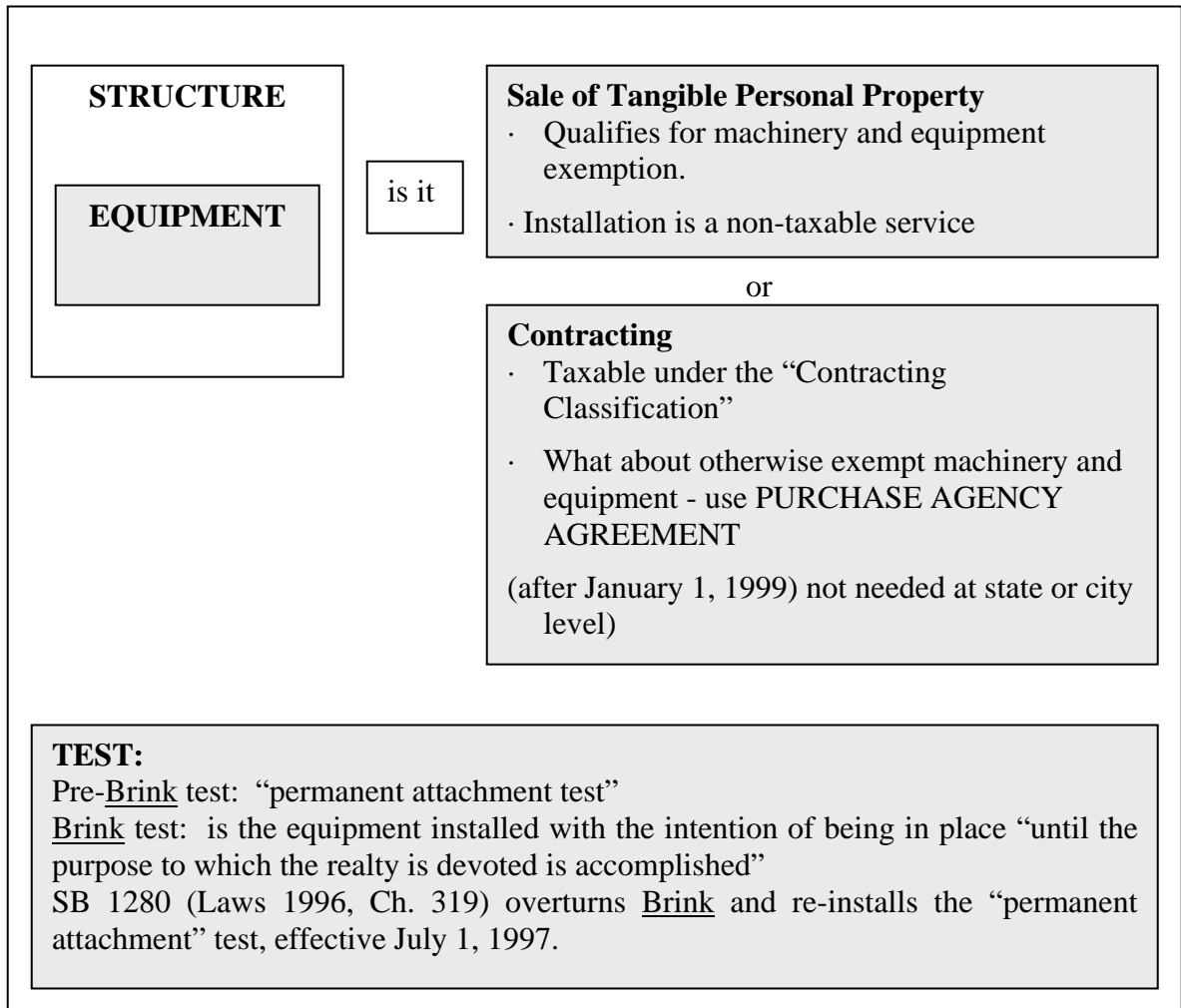
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## 1. BACKGROUND.



Arizona imposes a transaction privilege (sales) tax on prime contractors (subcontractors are exempt). This tax is imposed under the “contracting classification” of the Arizona sales tax statutes. Arizona also imposes a sales tax on the sale at retail of tangible personal property, under the “retail classification” of the Arizona sales tax statutes. The retail classification contains exemptions for the sale of machinery and equipment used in manufacturing, fabricating, job printing, mining and refining. The exemption also applies to machinery and equipment used in the generation and transmission of electricity, and certain transportation equipment and telecommunications equipment.

A long-standing issue in Arizona has been the characterization of the installation of otherwise exempt machinery and equipment. Is it contracting or does it fall under the retail classification?

If it is contracting, then the installation labor and the cost of the machinery and equipment will be subject to sales tax under the contracting classification (the tax base for this classification is 65% of the contractor’s gross receipts). The Arizona

Department of Revenue does not recognize the applicability of the machinery and equipment exemption, found under the retail classification, to the contracting classification and, thus, if that installation is characterized as contracting, the exemption is lost unless the contractor has a purchase agency agreement with the owner, to act as the owner's agent to purchase the exempt equipment. That purchase by the agent will fall under the retail classification, with the machinery and equipment exemption applying. But, the installation labor will still be subject to the sales tax under the contracting classification.

On the other hand, if the furnishing and installing of the exempt machinery and equipment is viewed as the retail sale of the machinery and equipment, the exemption will apply, and the installation labor will not be subject to Arizona sales tax.

It is this key to distinguish between when the installation of the machinery and equipment is contracting and when it is not, so that it falls under the retail classification with the exemption applying and the labor being tax exempt.

The established test has been one of "permanent attachment". However, the Arizona Court of Appeals in *Brink Electric Construction Co. v. The Arizona Department of Revenue*, 193 Ariz. Adv. Rptr. 56, 909 P.2d 424 (App. 1995), turned the contracting classification of the Arizona sales tax statutes upside down by rejecting the long-standing "permanent attachment" test. The Court held that the installation of removable electric substation equipment (the purchase of which is exempt from the sales tax under the "machinery and equipment exemption") is taxable contracting. The Court of Appeals in rejecting the "permanent attachment" test, established a less precise and lower threshold test to determine whether the installation of machinery and equipment is contracting. The Arizona Legislature reacted to the Court of Appeals decision and effectively overturned it in passing Senate 1280, Arizona Laws 1996, Chapter 319, and legislatively reinstated the old "permanent attachment", beginning July 1, 1997.

This article focuses on the old "permanent attachment" test, the *Brink* decision and Senate Bill 1280.

## **2. THE OLD "PERMANENT ATTACHMENT" TEST.**

R15-5-608.A provides that "installation of equipment which becomes permanently attached in a plant or other structure is taxable as contracting activity." The key words in the regulation are "permanently attached." The Department has taken the position that equipment fastened to the floor and walls of a building by nuts and bolts is permanently attached in spite of the fact that the equipment was removable without causing damage to itself or the building, the equipment was removed and relocated in various occasions, and the owner intended the equipment to be temporarily attached to facilitate such relocations.

The Department's position is open for challenge. Under the law of fixtures, a three-prong test has been established for determining when tangible personal property

has become permanently affixed to real property: (1) an annexation of the tangible personal property to the realty; (2) an adaptation of the tangible personal property to the use for which the real property is appropriate; and (3) an intention to make the tangible personal property a permanent occasion to the real property. Of the three factors, the greatest consideration is given to the intention of the parties. *Voight v. Ott*, 86 Ariz. 128, 341 P.2d 923 (1959); *Williams v. Long*, 1 Ariz. App. 330, 402 P.2d 1006 (1995).

Thus, even if equipment is attached to a building by nuts and bolts, where the method of annexation allows for removal without damage and the parties did not intend the equipment to be permanently attached, it is arguable that the equipment was not permanently attached. If the equipment is not permanently attached, then the installation is not taxable as a contracting activity.

### **3. PROPOSED REGULATION ON PERMANENT ATTACHMENT, BUT WITHDRAWN.**

A proposed amendment to R15-5-608 clarified the concept of “permanent attachment” to distinguish contracting activities from retail and rental transactions. It also adds that the contractor does not include in gross income the cost of machinery and equipment furnished by him if there is a written agreement between the contractor and the owner which provides that with respect to this property the transaction is a retail sale. Unfortunately, this proposed amendment was withdrawn by the Department in the spring of 1987. The proposed regulation, which did add some clarity to this area, provided:

R15-5-608. Installation of Machinery and Equipment by a Contractor.

- A. The contractor shall include in gross income:
  - 1. the receipts derived from the installation of machinery and equipment property that becomes permanently attached to land or to a structure; and
  - 2. the cost of the machinery and equipment furnished by the contractor unless:
    - a. there is a written agency agreement between the contractor and the owner authorizing the contractor to purchase this property for the account of the owner; or
    - b. there is a written agreement between the contractor and the owner which provides that with respect to this property the transaction is a retail sale.
- B. “Permanently attached” means that the machinery or equipment becomes a part of the realty. The determination of whether machinery or equipment has been permanently attached will depend on the particular facts of each situation.

Factors that indicate attachment include, but are not limited to, the following:

- a. the machinery or equipment is fastened to land or to a structure by means of cement, plaster, nails, bolts, screws, adhesive or wire;
  - b. the machinery or equipment cannot be removed from the land or structure without substantial effort or expense; or
  - c. the machinery or equipment cannot be removed without substantial damage to the land or to the structure.
- C. “Permanent” means that the machinery or equipment is not intended by its owner to be removed until its useful life is over or until the purpose to which the realty is devoted has been accomplished. Factors that indicate permanency include, but are not limited to, the following:
- a. the factors enumerated in 1.b and c of this subsection;
  - b. the contractor retains no rights of ownership or control over the machinery or equipment;
  - c. the machinery or equipment is located in a structure that was specifically designed or modified:
    - i. to accommodate the physical dimensions or weight of the machinery or equipment; or
    - ii. for the efficient use of the machinery or equipment;
  - d. the removal of the machinery or equipment would prevent its reuse for its original purpose; or
  - e. the machinery or equipment was specifically designed or modified:
    - i. for the physical characteristics of the land;
    - ii. to fit specific physical dimensions within a particular structure.

The imposition of the sales tax in the context of a contractor/retailer selling and/or installing equipment is, under the proposed regulation, dependent upon three factors. These are: the type of business classification, the type of consumer, and the type of tangible personal property which is the subject matter of the transaction. In relation to the installation of property by a contractor these three factors create various situations with different tax consequences. The Department has summarized these various situations:

2. a retailer who sells nonexempt property to a nonexempt consumer pays 5% tax on his gross income;
3. a retailer who sells a tax-exempt piece of equipment, such as an ore crusher to a mining company, pays no tax;
4. a retailer who sells property to a nonprofit charitable hospital, pays no tax;
5. a contractor who buys property for incorporation into a construction project would pass on the cost of this property plus a profit margin to the owner and pays 3.25% (65% of 5%) tax on his gross income;
6. a contractor who either buys tax-exempt property or who is furnishing property to a tax-exempt owner pays no tax if he is acting pursuant to a written agency agreement;
7. a contractor who makes a retail sale of nonexempt property to a nonexempt purchaser pays 5% tax on his gross income from the sale because he is acting as a retailer; and
8. a contractor who makes a retail sale pays no tax if the subject matter of the sale is tax-exempt property or if the purchaser is exempt from tax.

See Department's letter dated November 12, 1986, transmitting Proposed Regulation R15-5-608 to the Governor's Regulatory Review Council.

#### **4. BRINK REJECTS THE "PERMANENT ATTACHMENT TEST".**

The *Brink* case involved two issues. The first was whether a purchase agency agreement was necessary for a contractor to claim an exemption for otherwise exempt machinery and equipment the contractor installed. The Court of Appeals held that a purchase agency agreement was, in fact, necessary for a contractor to claim exemptions for otherwise exempt machinery and equipment. The Court of Appeals determined that the machinery and equipment exemptions were under the retail classification and were not available to contractors, unless they had a purchase agency.

The second issue, which is the focus of this article and Senate Bill 1280 involved the question of whether Brink was engaged in taxable contracting or in the non-taxable installation of exempt machinery and equipment. Brink had argued that it was not engaged in contracting because none of the machinery and equipment it installed became permanently attached to the realty or a structure. Brink furnished and installed otherwise exempt electric transmission equipment, such as transformers and power disconnect switches. Brink had argued that none of that equipment became permanently attached to the land or a structure. It merely sat on concrete blocks, most of it without even being bolted down. Brink was also able to establish at the Tax Court level that there was a secondary market for used transformers and power disconnect switches. In fact, Brink had a contract with the federal government to remove the same

transformers it had installed at the Glen Canyon substation site and install them elsewhere.

The Tax Court concluded that the machinery and equipment did not become permanently attached and therefore Brink was not engaged in contracting. The “permanent attachment” test was based on the Department of Revenue’s own regulations dealing with when a contractor will be taxable under the contracting classification when installing machinery and equipment. This is Regulation R15-5-608.A, entitled Installation of Equipment. It provides that “installation of equipment which becomes *permanently attached* in a plant or other structure is taxable as a contracting activity.” (Emphasis added.) The converse is that if the machinery and equipment does not become permanently attached, the installer is not engaged in contracting and is not taxable under the contracting classification.

The Court of Appeals, though, rejected this permanent attachment test, holding that Brink had engaged in contracting since it modified or altered real property by installing the transformers and other electrical transmission equipment and met the definition of contractor under A.R.S. § 42-5075.G.1. The Court of Appeals test was whether the item was installed with the intention of being in place “until the purpose to which the realty is devoted is accomplished.” Permanent attachment, or permanently affixed, meant to the Court of Appeals something which is put in place which is intended to stay unless “a change occurred in the particular type or level of use of the real property.”

In short, the Court of Appeals rejected the permanent attachment test, substituting a concept of probable long-term use, in its place.

Brink filed a petition for review with the Arizona Supreme Court. However, in January 1996, the Arizona Supreme Court denied review, so the Court of Appeals’ decision stands as being the law with respect to the installation of machinery and equipment and when it will be considered contracting.

## **5. SENATE BILL 1280 REINSTATES THE TEST.**

Senate Bill 1280, Laws 1996, Ch. 319, legislatively overturns the *Brink* court of appeals’ decision and reinstalls the former “permanent attachment” test.

The legislation enacts a new A.R.S. § 42-5075.B.9, which provides a deduction for:

The gross proceeds of sales or gross income derived from a contract entered into for the installation, assembly, repair or maintenance of machinery, equipment or other tangible personal property that is deducted from the tax base of the retail classification pursuant to § 42-5061, subsection B, that does not become permanently attached to a building, highway, road, railroad, excavation or manufactured building or other structure, project, development or improvement.

“Permanently attached” is defined by that same subsection B.7 to mean at least one of the following:

- a. To be incorporated into real property.
- b. To become so affixed to real property that it becomes a part of the real property.
- c. To be so attached to real property that removal would cause substantial damage to the real property from which it is removed. If the ownership of the realty is separate from the ownership of the machinery, equipment or tangible personal property, the determination as to permanently attached shall be made as if the ownership were the same. The deduction provided in this paragraph does not include gross proceeds of sales or gross income from that portion of any contracting activity which consists of the development of, or modification to, real property in order to facilitate the installation, assembly, repair, maintenance or removal of machinery, equipment or other tangible personal property that is deducted from the tax base of the retail classification pursuant to § 42-5061, subsection B.

The cross-reference to § 42-5061, subsection B is to the machinery and equipment exemptions contained under the retail classification.

A prime contractor must establish entitlement to the deduction by both:

- a. Marking the invoice for the transaction to indicate that the gross proceeds of the sales or gross income derived from the transaction was deducted from the base.
- b. Obtaining a certificate executed by the purchaser indicating the name and address of the purchaser, the precise nature of the business of the purchaser, the purpose for which the purchase was made, the necessary facts to establish the deductibility of the property under § 42-1310.01, subsection B, and a certification that the person executing the certificate is authorized to do so on behalf of the purchaser. The certificate may be disregarded if the prime contractor has reason to believe that the information contained in the certificate is not accurate or complete.

A contractor that does not comply with those two requirements may still establish entitlement to the deduction by presenting facts necessary to support the entitlement, but the burden of proof is on that contractor.

The legislation also authorizes the Department to prescribe a form for the certificate and to promulgate rules that describe the transactions with respect to which a person is not entitled to rely solely on the information contained in the purchaser's certificate.

Finally, the legislation provides that the Department may require the purchaser which gave the certificate to the contractor to establish the accuracy and completeness of the information required to be contained in the certificate which would entitle the prime contractor to the deduction. If the purchaser cannot establish the accuracy and completeness of the information, the purchaser is liable in an amount equal to any tax, penalty and interest which the prime contractor would have required to pay. Payment of such amount exempts the purchaser from any use tax on the items of machinery and equipment in question.

This legislation has a delayed effective date, and is not effective until July 1, 1997. Moreover, this legislation is not intended to affect, and shall not be cited or considered in, the construction or interpretation of § 42-1310.16, with regard to issues involving tax periods beginning before July 1, 1997. A copy of Senate Bill 1280 is attached as *Appendix A*.

## **6. DEPARTMENT'S TRANSACTION PRIVILEGE TAX RULING IMPLEMENTING SENATE BILL 1280.**

On July 15, 1997, the Department issued its Transaction Privilege Tax Ruling TPR 97-3, implementing Senate Bill 1280. It was released just fifteen days after the effective Senate Bill 1280. The ruling is recapped here and a full copy is attached as Appendix B.

### *A. The Deduction Under A.R.S. § 42-1310.16(B)(7) For Labor Involved In Installation of Machinery And Equipment That Does Not Become Permanently Attached.*

The statute defines "permanently attached" to mean at least one of the following:

1. The tangible personal property is incorporated into real property;
2. The tangible personal property is so affixed to real property that it becomes a part of the real property; or
3. The tangible personal property is so attached to real property that removal would cause substantial damage to the real property from which it is removed.

The Department's ruling indicates that the existence of any one of the three factors means that the tangible personal property is permanently attached and the income from the installation contract is subject to tax under the prime contracting classification. Further, the ruling provides that if the machinery and equipment

exemption applies, and the machinery and equipment is not permanently attached under the above tests, the deduction is only for the income derived from the installation, assembly, repair or maintenance of the machinery or equipment, and does not also apply to the machinery and equipment itself. As indicated further on, the Department's position is that an Agency Agreement is still required for the contractor to secure an exemption for the cost of the exempt machinery and equipment itself.

B. *Machinery And Equipment That Qualifies For The Installation Labor Deduction.*

This part of the Department's rulings lists all of the various items of machinery and equipment that qualify for the exemption. They are set forth in A.R.S. § 42-1310.01(B), and include machinery and equipment used in manufacturing, processing, fabricating, job printing, refining or metallurgical operations; mining machinery or equipment; certain tangible personal property used by telecommunications companies; machinery or equipment or transmission lines used in producing or transmitting electrical power; pipes or valves 4 inches in diameter or larger; etc.

The Department's ruling indicates that deductions added in the future under A.R.S. § 42-1310.01(B) for new categories of exempt machinery and equipment will also qualify for the deduction under A.R.S. § 42-1310.16(B)(7), for installation labor.

C. *Agency Agreements*

It is the Department's position that, even under Senate Bill 1280, and even if machinery and equipment is not permanently attached, the contractor, in order to secure the exemption for the machinery and equipment, must have a purchase agency with the owner. Without the purchase agency in place, it is the Department's position that the contractor is not entitled to the exemption for the machinery and equipment that was installed, even though the installation labor will not be subject to sales tax.

D. *Two Separate Lines of Businesses.*

The Department recognizes that it is possible for a person to be engaged in two lines of business, citing *State Tax Comm. v. Holmes & Narver, Inc.*, 113 Ariz. 165, 548 P.2d 1162 (1976).

The Department, though, makes a distinction between business activities which are incidental to the principal business and interwoven in the operation to the extent that they are in effect an essential part of the major business, from businesses that are not incidental to the primary business, such as contracting. If the business activity is incidental to the principal business and an integral part of the operation of the principal business, then they will not be taxed as a separate business. The Department's primary reliance for this conclusion is *Arizona Rent-A-Car Systems, Inc. v. City of Phoenix*, 182 Ariz. 75 893 P.2d 75 (App. 1995) (gasoline refueling charges, were held to be a integral part of the rental car business).

E. *Retailer/Prime Contractor Separate Lines of Businesses.*

The Department then zeroes on the real issue as it relates to Senate Bill 1280 and that is where a person engages in two separate lines of business and one line of business is as a retailer and other line of business is as a prime contractor. The Department concludes that if the retail business is not an integral part of the contracting business, the person may make sales of the exempt machinery and equipment at retail without an agency agreement, and be entitled to the exemption. The determination of whether or not a person engages in two separate lines of business depends on the facts and circumstances surrounding the business. Suffice to say, the Department will very likely take a close look at a contractor that also purports to be a retailer of exempt machinery and equipment. As a practical matter, and to avoid this problem, such a contractor should consider having two separate legal entities (two separate corporations, two separate limited liability companies, etc.) to avoid this problem. One corporation would be the contracting business and the other corporation, with its separate sales tax license number, would be the retailer of the exempt machinery and equipment.

F. *Exemption Certificate To Support Labor Exemption.*

The Department indicates that the normal transaction privilege tax exemption certificate should be used to document the deduction for the exempt installation labor. The purchaser (the one with the project) should provide that exemption certificate to the contractor and check the box marked "19 Other" and indicate § A.R.S. 42-1310.16(B)(7) as the statutory authority for the exemption. The purchaser should also provide a detailed description of the type of property purchased and the use of that property.

The ruling also indicates that if the contractor has entered into a valid, written Purchase Agency Agreement with the owner, the contractor or owner should provide the vendor of the exempt machinery and equipment with a tax exemption certificate, indicating that the machinery and equipment is exempt machinery and equipment.

G. *Ruling.*

The Department concluded that a prime contractor may deduct from its tax base the gross income derived from a contract to install, assemble, repair or maintain exempt machinery, equipment or other tangible personal property that does not become permanently attached to the project.

The contractor is entitled to deduct the cost of the exempt machinery and equipment only to the extent that the contractor has entered into a valid purchase agency agreement with the owner. Or, the contractor may be entitled to the exemption if the contractor engages in a completely separate independent line of business as a retailer that sells such exempt machinery and equipment. In that case, a purchase agency is not needed. *Caution:* The Department will look at the facts and circumstances of each case to see if the contractor has a separate, independent line of

business as a retailer. It is recommended that to avoid this problem, as indicated above, two separate legal entities be established to carry on the two separate lines of business.

If the contractor does not have a Purchase Agency Agreement, and even though the machinery and equipment is not permanently attached, the Department has ruled that the contractor will not be entitled to the machinery and equipment exemption for the cost of that otherwise exempt machinery and equipment.

*NOTE: Purchase agency agreement requirement repealed.* The Department's ruling is based on the *Brink* case which required that a purchase agency agreement be in place for a contractor to be able to deduct the cost of exempt machinery and equipment which it installed. As pointed out below, the purchase agency agreement was repealed by the legislature, effective January 1, 1999. Accordingly, the Department's ruling to the extent that it requires that a purchase agency be in place, has been superseded by the legislative repeal of the purchase agency agreement requirement. See Laws 1998, chapter 90, (S.B. 1323) and A.R.S. § 42-5075.B.9. The examples given in the ruling, which are summarized below, again to the extent that they require a purchase agency agreement, are no longer accurate and valid in light of the legislative repeal of the purchase agency agreement requirement. The materials presented on the purchase agency agreement requirement while having no applicability for construction contracts and projects started after January 1, 1999, nevertheless are still important and controlling for contracts and construction projects that took place before that date, since the purchase agency agreement format was required then.

#### H. *Examples.*

The ruling provides a number of examples. They are summarized below:

1. *Permanent Attachment With A Valid, Written Purchase Agency Agreement.* In this case, the contractor will not be entitled to a deduction for the installation labor of the exempt machinery and equipment but will be entitled to the machinery and equipment exemption for the cost of that machinery and equipment.
2. *Permanent Attachment Without A Valid, Written Purchase Agency Agreement.* In this case, the contractor is essentially out of luck. It will not be entitled to the deduction for installation labor and will not be entitled to the exemption for the cost of the exempt machinery and equipment.
3. *No Permanent Attachment With A Valid, Written Purchase Agency Agreement.* This is the best case scenario. The contractor will be entitled to the installation labor deduction and will also be entitled to the exemption for the cost of the exempt machinery and equipment.
4. *No Permanent Attachment And No Valid, Written Purchase Agency Agreement.* The contractor will be entitled to the installation labor

deduction but will *not* be entitled to the machinery and equipment exemption.

5. *No Permanent Attachment With A Valid, Written Purchase Agency Agreement When The Qualifying Machinery And Equipment Was Purchased By The Prime Contractor Prior to July 1, 1997.* The Installation Of The Machinery And Equipment Will Take Place Both Before And After July 1, 1997. The contractor will be entitled to the installation labor deduction for installation that took place after July 1, 1997. It will not be entitled to the installation labor deduction for installation that took place prior to July 1, 1997. The contractor will be entitled to the machinery and equipment exemption because of the existence of the Purchase Agency Agreement.

6. *Retail Sale Of Qualifying Machinery And Equipment With Installation.* The example the Department gives is that a retailer sells a copier to a job printer. The retailer delivers the copier to the job printer's premises and sets it up. The Department concludes that the sale of the copier to the job printer qualifies for the machinery and equipment exemption (with no need for a purchase agency) and the installation labor is deductible as services under A.R.S. § 42-1310.01(A)(2). This situation deals with a retailer and not a contractor. Thus, the installation labor deduction and purchase agency concepts do not come into play at all.

**7. ARIZONA OUTDOOR ADVERTISERS CASE -- DEPARTMENT WIL USE AS TEST FOR PERMANENT ATTACHMENT.**

*The Court of Appeals in Arizona Department of Revenue v. Outdoor Advertisers, Inc., 202 Ariz. 93, 41 P.3D 631 (CT. APP. 2002), established a new "reasonable person" for determination of real property versus personal property for tax purposes.*

As background, the Department assessed sales tax on the taxpayer's rentals of advertising billboards as commercial leases of real property. The billboards consisted of modular frameworks bolted to support poles driven several feet down into the ground. Customers' advertising panels were hung on the frameworks. The billboards were designed to be easily disassembled. They were erected on land leased from third parties, and the leases permitted their removal upon one month's notice. Advertising locations were abandoned whenever they became unprofitable. To remove the billboard, the support poles were severed at the ground level, and the entire unit was hauled to its next location. The taxpayer protested the assessment as employing the wrong sales tax classification, because it rented personal property.

While the Tax Court employed a traditional fixtures analysis to determine whether the billboards were personal or real property, the Court of Appeals found a "reasonable person" test preferable for tax purposes. The test inquires whether a

reasonable person, considering all the relevant circumstances, would assume the item in question was a part of the real estate where it was located. The right to remove the billboards, their design, and the fact that removal took place frequently outweighed the affixture of the support poles and warranted finding that the billboards were personal property.

The Department has indicated that it will use the Arizona Outdoor Advertisers case as test for determining permanent attachment for purposes of the installation labor exemption of A.R.S. § 42-5075.B.7.

## **8. PURCHASE AGENCY AGREEMENT FOR CONTRACTORS’ PURCHASES OF EXEMPT MATERIALS.**

*NOTE: Purchase agency agreement requirement repealed effective January 1, 1999.* As pointed out below, the need for the purchase agency agreement structure was repealed by the legislature, effective January 1, 1999. See Laws 1998, chapter 90 (S.B. 1323) and A.R.S. § 42-5075.B.9. Since the purchase agency agreement was required for periods prior to January 1, 1999, the following material is still relevant and useful. Remember, there is a four-year statute of limitations and a construction project that involved exempt machinery, equipment and materials would still be subject to the old purchase agency requirements, and in any audit the Department would surely confirm the existence of a purchase agency agreement in order to allow the exemption for exempt machinery, equipment and other materials.

### ***8.1 Exempt Equipment.***

A.R.S. § 42-5061.B exempts “retail sales” of, among others, the following types of personal property from the Sales Tax:

- a. Machinery or equipment used directly in the manufacturing processing, fabricating, job printing, refining or metallurgical operations. A.R.S. § 42-5061.B
- b. Machinery or equipment used directly in mining. A.R.S. § 42-5061.B.2 .
- c. Certain tangible personal property used by telephone and telegraph companies. A.R.S. § 42-5061.B.3.
- b. Personal property used in electric power production and transmission (but not distribution). A.R.S. § 42-5061.B.4.
- c. Pipes or valves four inches in diameter or larger used for transporting oil, natural gas, artificial gas, water or coal slurry. A.R.S. § 42-5061.B.6.

If a contractor has been engaged to build a structure which would also require the provision of the types of machinery or equipment or personal property listed above,

the contractor should enter into a purchase agency agreement with the owner to purchase those materials as the owner's agent. *See* Regulation R15-5-608. If the contractor does not and lumps those items in his construction contract, the Department takes the position that the Sales Tax exemption for those items will be lost.

## ***8.2 DOR Ruling On Purchase Agency Agreements.***

The Department issued a Transaction Privilege Ruling TPR 95-21 on the subject of purchase agency agreements. A copy of that ruling is attached as *Appendix C*. In the ruling, the Department sets out the requirements for a valid purchase agency agreement. If such a valid purchase agency agreement is in place, then the Department of Revenue will honor the various machinery and equipment exemptions for such items purchased by the contractor as the agent for the owner. Without the agency agreement in place, the Department will disallow the machinery and equipment exemption.

The Department lays out four requirements or elements for a valid agency agreement.

1. There must be a provision in the agreement which manifests the intent to create an agency relationship. The Department provides the following example.

Contractor, and its subcontractors, shall act as Owner's agent for the purpose of making approved purchases of machinery, equipment, materials and other tangible personal property required under the terms of the contract to which this agreement is appended (or contract in which this agreement is incorporated). No other provision in the contract shall negate or modify the provisions of this agency agreement.

2. There must be a provision which vests in the agent the authority to make purchases on behalf of the principal and to bind the principal. The Department provides the following suggested language:

All machinery, equipment, materials and other tangible personal property shall be purchased by the Contractor and its subcontractors on behalf of and for the account of Owner as its agent. Title to the subject property shall pass directly from the vendor to Owner. Neither the Contractor nor any of its subcontractors shall acquire any ownership interest in such property.

In making such purchases, the Contractor and any of its subcontractors shall include the following language on the purchase orders:

Purchaser. The name and address of the purchaser on all order forms shall be:

“(Owner)” OR “(Contractor), as agent for (Owner)” (Owner’s address).

Signature. The signature on all purchase orders shall be:

“(Contractor), as agent for (Owner)”

To substantiate that the contractual provisions are not merely matters of form, the purchases should be made by one of the following methods:

3. *Owner Pays For Purchases.* The purchases are made in the name of the principal; with the principal’s funds or credit, either in the form of cash advances or checks drawn on a separate bank account maintained by the principal; and, title to the items purchased passes to the principal at the time of purchase.
4. *Agent Pays For Purchases.* The purchases are made in the name of the principal, with the agent’s funds or credit. In this case the transactions must be segregated. The agent must maintain separate, detailed accounting records for these purchases.

The Department recognizes that various approaches to the drafting an execution of an agency agreement and exist, such as that of an undisclosed principal. The Department notes that if the language of the agreement and the associated conduct of the parties is other than as set out in the examples contained in the ruling (Nos. 1 through 4 above), the agency agreement is subject to review by the department as to the facts and circumstances surrounding its execution. The burden of proof as to the validity of the agreement lies with the taxpayer.

### **8.3 A History Of The Purchase Agency Agreement Litigation: The Ball, Ball and Brosamer Case--Purchase Agency Required Or Not?**

*Board of Tax Appeals Decision--Required.* In *Ball, Ball and Brosamer, Inc. v. Arizona Department of Revenue*, Arizona Board of Tax Appeals, Division Two, No. 710-89-S (December 12, 1990), the Board held that a prime contractor’s transfer, pursuant to its construction contracts, of four-inch diameter pipes and valves used to transport water was not exempt from Sales Taxation. A.R.S. § 42-5061.B.6 exempts from the Sales Tax under the retail classification the sale of pipes or valves four inches or larger in diameter used to transport oil, natural gas, artificial gas, water or cold slurry. The Board held that because this exemption is available only to those taxpayers taxable under the retail classification and not to those taxable under the prime

contracting classification, the prime contractor was liable for the payment of the Sales Tax on the cost of those materials.

*Tax Court Decision--Not Required.* The tax court reversed the Board of Tax Appeal's decision in the *Ball, Ball and Brosamer* case. The tax court held that a purchase agency agreement was not required for the contractor, Ball, Ball and Brosamer, to claim the pipes and valves exemption. The tax court reasoned that such a purchase agency requirement in a contractor situation violated the equal protection clause because such a purchase agency agreement was not required by the Department in a noncontractor situation. The tax court's decision has been appealed by the Department of Revenue to the Court of Appeals, where the case is in the briefing process. A copy of the *Ball, Ball and Brosamer* decision, which was consolidated with the *Brink* case, is attached.

*Court of Appeals Reverses the Tax Court, Requires Purchase Agency.* In a June 29, 1995 decision, the Arizona Court of Appeals in *Brink Electric Construction Company and Ball, Ball & Brosamer, Inc. v. Arizona Department of Revenue*, Nos. 1 CA-TX 93-0010 and 1 CA-TX 94-0011 (Consolidated), overturned the Tax Court's decision and required a purchase agency agreement to take advantage of the machinery and equipment exemptions. The Court of Appeals concluded that the machinery and equipment exemptions were under the retail classification and thus were not available to contractors. The Tax Court had come to the same result but held that it was denial of Ball and Brink's equal protection rights to require a purchase agency agreement. This equal protection violation was based on two grounds:

1. The Department of Revenue in previous years had allowed contractors, such as Ball and Brink, to claim exemptions for machinery and equipment, along with four-inch pipes and valves, etc. without the need of a purchase agency agreement, in fact, giving refunds to some. Not to allow Ball and Brink to claim the exemptions just because they did not have a purchase agency, the taxpayers argued violated their equal protection rights.

2. Contractors that had purchase agencies in place received the benefit of the exemptions. Those that did not, did not. There is really no difference in the two situations, other than the piece of paper. Both contractors with and without purchase agencies acted and performed their construction and installation activities in the same manner. The denial of an exemption to those who did not have the purchase agency, the taxpayers argued, was a denial of their equal protection rights. The Tax Court based its equal protection decision on the second argument.

The Court of Appeals rejected both equal protection arguments, and overturned the Tax Court. The result, now, is that a purchase agency must be in place for a contractor to take advantage and claim the machinery and equipment exemptions. This case, which is consolidated with the *Brink* case, is currently pending the Arizona Supreme Court's action on the taxpayers' petition for review on the purchase agency issue and the *Brink*, permanently attached issue.

#### **8.4 Hospital Projects.**

A.R.S. § 42-5061.A.25 exempts from the Sales Tax all personal property purchased by a “qualifying hospital,” which is defined in A.R.S. § 42-5001.11. Again, if a contractor is constructing a project for such a hospital, the contractor should have a separate agreement in which the contractor agrees to purchase the building materials as the agent of the hospital in order to take advantage of the hospital exemption. If this is done, R15-5-629.B provides that the cost of such property will not be deemed to be contracting income, even though it is installed or incorporated into the hospital construction project. *See also Kitchell Contractors, Inc. v. City of Phoenix*, 151 Ariz. 139, 726 P.2d 236 (App. 1986).

#### **8.5 U.S. Government Projects.**

A.R.S. § 42-5061.K provides that the Sales Tax shall not apply to sales made directly “[t]o the United States government, its departments or agencies by a manufacturer, modifier, assembler or repairer.” A.R.S. § 42-5061.L provides a 50% Sales Tax deduction for sales by a retailer (who is not a manufacturer, modifier, assembler or repairer) directly to the United States governments, its departments or agencies. If a contractor is engaged to build a project for the United States government, the contractor could enter into a purchase agency agreement with respect to the building materials. If that is done, the contractor should be able to deduct the full cost of the building materials if purchased from a manufacturer, etc., or 50% if purchased from a non-manufacturer, etc.

### **9. LEGISLATIVE REPEAL OF PURCHASE AGENCY AGREEMENT REQUIREMENT, EFFECTIVE JANUARY 1, 1999.**

The Arizona Legislature in 1998 passed legislation which did away with the need of purchase agency agreements in the prime contracting situation. The legislation, Laws 1998, chapter 90 (Senate Bill 1323) eliminated the need for contractors to enter into a purchase agency agreement with property owners when selling and installing certain machinery and equipment that qualifies for a deduction under the retail classification and use tax statutes (the machinery and equipment deductions). In addition, prime contractors will no longer be required to enter into purchase agency agreements when performing work for qualifying hospitals and health care centers.

The legislation accomplishes this by providing a deduction under the prime contracting classification for machinery and equipment that is exempt under the retail classification and use tax statutes. The new legislation is effective beginning January 1, 1999. *See A.R.S. § 42-5075.B.9.*

The purpose of the Bill is to legislatively overrule the *Brink* case, to the extent that it required purchase agency agreements. The legislation also states that it is not intended to effect prior interpretations of the sections of the Arizona Revised Statutes being amended. In other words, it is not meant to be retroactive and not meant to

effect the outcome of the *Brink* case, for any periods prior to its effective date of January 1, 1999.

*Model City Tax Code Amended.* The Model City Tax Code was also amended to incorporate the repeal of the purchase agency agreement requirement. See Model City Tax Code Section -415(b)(4). The Model City Tax Code amendment is retroactively effective, as the state repeal is, to January 1, 1999.