CURRENT ARIZONA DEVELOPMENTS
Legislation and Cases

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2005 CASES

Qwest Dex, Inc. v. Arizona Department of Revenue,* _____ Ariz. ____, _____ P.3d _____, 2005 WL 768449 (App. April 5, 2009).** ***Cost Of Out Of State Printing Services Not Subject To Arizona Use Tax; Only Cost Of Paper Subject To Use Tax. Qwest Dex publishes the white pages and yellow pages telephone directories. It purchases the paper that it needs for those directories from out of state paper mills and has the paper shipped to out of state printers for printing of the directories. The taxpayer initially paid the use tax on the purchase price of the paper from the out of state paper mill and on the printing services. The taxpayer then filed a claim for refund for the amount of taxes paid on the cost of the printing services but agreed that the use tax applied to the cost of the paper purchased from the out of state paper mill. The Department audited Qwest Dex and asserted use tax on the cost of the printing services. The Arizona use tax is imposed upon the purchase of tangible personal property from an out of state retailer where that property is brought in to the state and is used, consumed or stored in Arizona. The measure of the use tax is the acquisition cost of the tangible personal property as purchased from the out of state retailer. The use tax does not apply to services. The Tax Court held that the printing services, being services, were not taxable under the retail classification and thus would not be subject to the Arizona use tax. The Court of Appeals agreed, applying what is called the "common understanding test." Under this test, whether a transaction qualifies as a sale of tangible personal property or the sale of a service is determined by the parties' common understanding of the particular trade, business or occupation. Using the common understanding test, the court determined that the taxpayer does not owe a use tax on the printing of the directories because printers provide a service. The court observed that the very nature of the term "printing" denotes a service and not a tangible item. The court also cited to several out of state cases that held printers who print specific material on paper for a customer are not engaged

in the business of selling tangible personal property, but are instead engaged in a service, reasoning that the paper is of no use to anyone except the customer for whom the printing is done.

The court also noted that the printing service would be taxed in Arizona under the job printing classification of the transaction privilege tax but held that this varying treatment would not change the court's conclusion as to the use tax. The court reasoned that the job printing classification, unlike the use tax, specifically includes a provision for a tax on printing services while the use tax, in contrast, imposes no specific tax on printing services.

2004 TAX LEGISLATION[1]

House Bill 2040 (Ariz. Sess. Laws 2004, Chapter 61). ***2004 Tax Corrections Act; Qualifying Hospital And Handicapped Program Exemptions Clarified.*** This Bill makes the following technical and clarifying changes, among others, to the Transaction Privilege Tax statutes:

(i) Current law provides that a contractor can deduct the cost of building materials with respect the construction of a facility for a qualifying hospital. When a new hospital is being constructed, it would not meet the definition of a qualifying hospital because it is not yet licensed by the state (which is a requirement for the deduction). The current statute provides that when such a facility is under construction and then on completion will qualify as a "qualifying hospital," the deduction will nevertheless apply. *See* A.R.S. § 42-5001(11). Such a qualifying hospital may give the contractor an exemption certificate based on the condition that the hospital will qualify and will be licensed when construction is completed. Current law provides that if such an exemption certificate is given, if the conditions are not met within a "reasonable time," then the tax is due. *See* AR.S. § 42-5009(G). This Bill defines "reasonable time" as the time limitation that the Department determines, which may not exceed the time limitations provided by the statutes of limitations of A.R.S. Section 42-1104.

(ii) The Bill clarifies the transaction privilege tax exemption for the sale of tangible personal property to non-profit charitable organizations for programs that are exclusively for mentally or physically handicapped persons. The Bill clarifies that the exemption is only available if the programs are "exclusively for" training, job placement, rehabilitation or testing. *See* A.R.S. § 42-5061(B)(29*)*.

House Bill 2459 (Ariz. Sess. Laws 2004, Chapter 143). ***First Month's Car Lease Payment Not Taxable To Dealer If Lease Is Assigned To A Leasing Company.*** This Bill provides a deduction under the personal property rental classification for the first month's lease payment received by an automobile dealer when the dealer assigns the lease to a third party leasing company.

[1] The effective date of 2004 legislation is August 25, 2004, unless otherwise noted.

Senate Bill 1141 (Ariz. Sess. Laws 2004, Chapter 234). ***Sales Tax Rate Increases: Blanket Grandfather Provision For Pre-existing Transactions.*** This bill provides a blanket grandfather provision with respect to all taxable classifications except the contracting classification for state sales tax rate increases. Specifically, the Bill provides that a state transaction privilege tax rate increase will not take effect with respect to pre-existing transactions where there is a written contract in place until 120 days after the effective date of the rate increase. The Bill also provides that it does not apply to any taxpayer that has entered into a contract which contains a pass-through provision allowing the taxpayer to recover the increased tax amount from the purchaser. This provision applies regardless of the accounting method used by the taxpayer and does not apply to any rate increases for county excise taxes.

For construction contracts, the prime contracting classification of A.R.S. Section 42-5075 has a specific grandfather provision for pre-existing construction contracts. This Bill's grandfather provision applies to all other classifications.

Senate Bill 1001 (Ariz. Sess. Laws 2004, Chapter 240). ***Exemption For A Railroad's Transportation Of Fertilizer.*** This Bill provides a new exemption from the transporting classification of the transaction privilege tax for amounts received by a railroad for the transportation of fertilizer from one point in Arizona to another point in the state. This Bill is effective from and after September 30, 2004.

House Bill 2086 (Ariz. Sess. Laws 2004, Chapter 242). ***Sales Tax Refund To Auto Manufacturer On Repurchase Of "Lemon" Vehicles.*** This Bill provides a refund mechanism for automobile manufacturers who repurchase vehicles from consumers under Arizona's lemon laws. If a vehicle is deemed to be a "lemon" under the Arizona lemon law provisions, the dealer is required to repurchase the vehicle and will now receive a refund of sales taxes paid on the purchase of the vehicle if the following conditions are met:

(i) The manufacturer must repurchase a vehicle under Arizona's lemon law provisions or for "reason of consumer satisfaction."

(ii) The manufacturer is required to refund the amount of the sales tax to the consumer; and

(iii) The manufacturer must provide the Department with "satisfactory proof" that the sales tax with respect to the lemon vehicle was i) collected from the consumer and ii) refunded by the manufacturer to the consumer.

If a refund is paid to the manufacturer, that refund is in lieu of a refund of sales taxes that the dealer would otherwise be entitled to receive.

House Bill 2460 (Ariz. Sess. Laws 2004, Chapter 296). ***Sales of Motor Vehicles To Nonresidents.*** Under current sales tax law, a nonresident may purchase a motor vehicle in Arizona and not be subject to Arizona sales tax if the nonresident secures a thirty (30) day nonresident registration permit for the vehicle and the nonresident's home state does not allow a corresponding use tax exemption for Arizona sales tax with respect to the purchase of the vehicle. *See* A.R.S. § 42-5061(A)(28). It amends the statutes dealing with the motor vehicle

division's thirty (30) day nonresident registration permit certificates to require a nonresident motor vehicle purchaser to affirm that the vehicle is to be registered in another state within thirty (30) days. That requirement was not part of prior law. This Bill also provides that if the purchaser registers the vehicle in Arizona within 365 days after getting the thirty (30) day nonresident registration permit, the purchaser will be liable for any Arizona transaction privilege tax, county excise tax, penalties and interest that the motor vehicle dealer would have been required to pay. See new A.R.S. Sections 28-2154 and 28-2154.01.

It should be noted that this Bill does not apply to the transaction privilege tax exemption for motor vehicles sold to nonresidents where the vehicles were delivered out of state. *See* A.R.S. § 42-5061(A)(14).

Senate Bill 1293 (Ariz. Sess. Laws 2004, Chapter 309). ***Legislation Clarifies That Design Services Are Not Subject To Tax Under The Prime Contracting Classification.*** As background, the Department of Revenue in two recent audits took the position that the design portion of a "design-build" contract was subject to tax under the prime contracting classification even though the design revenue was separately invoiced and accounted for. The Arizona Supreme Court made clear in the *Ebasco, Holm*es *& Narver* and *Parsons-Jurden* cases that design and engineering work was not subject to tax under the prime contracting classification. This legislation reflects the holdings in those cases and clarifies that design, engineering and architectural services are not subject to tax under the prime contracting classification even when undertaken by a contractor. It provides an exclusion from the contracting classification for the direct cost of such design, engineering and architectural services. When a prime contractor subcontracts out the design and engineering services to a third party, the direct costs will be the amount paid to that third party. If the contractor performs those services in-house, the direct cost will essentially be the labor expense of personnel for performing those services, without any allocation of overhead (such as rent, utilities, etc.).

This legislation is retroactively effective to October 17, 1969, which is the date of the *Ebasco* decision. The Bill also provides a mechanism for requesting refunds of taxes paid on such design and engineering services. A client's refund must be submitted to the Department of Revenue by December 31, 2004. The aggregate amount of refunds to be provided to taxpayers submitting refund claims is $100,000. If the total amount of refund claims exceeds $100,000, then each taxpayer will receive a prorata refund amount. The $100,000 aggregate refund cap limitation and the December 31, 2004 deadline for submitting refund claims should apply only to refund claims that would be now barred by the statute of limitations (four years). Claims for refund that are filed within the four year statute of limitations (as an example, for the year 2002 or 2003) should not be subject to the $100,000 refund limitation.

House Bill 2277 (Ariz. Sess. Laws 2004, Chapter 318). ***Sales Tax Exemption For Purchases Of Electricity And Other Energy By The Central Arizona Water Conservation District.*** This Bill exempts from the sales and use tax the purchase of electricity or other energy forms by the Central Arizona Water Conservation District that is used to pump CAP water. This Bill is retroactively effective to January 1, 1985 (see Section 13 of the Bill).

Senate Bill 1288 (Ariz. Sess. Laws 2004, Chapter 337). ***Sales Tax Treatment Of "Bundled" Telecommunications Services.*** Under current law, if a "bundled" transaction includes both

taxable and nontaxable items (and since they are bundled, the nontaxable item is not separately stated), the entire amount will be subject to sales tax. This Bill provides that "bundled" telecommunications services can be allocated among their various components so that only the taxable items will be subject to tax. This Bill adds a methodology for the identification of nontaxable charges on bundled transactions and allows a telecommunications company to elect to use allocation percentages derived from its entire service area instead of itemizing individual calls. The Department of Revenue may request the allocation information and may perform an audit to verify the allocation. Additionally, the telecommunications service provider must waive its right to any refund on taxes if the taxes paid were based on the allocation percentage deemed reasonable at the beginning of the tax year at issue.

2004 CASES

State ex rel. Arizona Department of Revenue v. Capitol Castings, Inc.*, 207 Ariz. 445, 88 P.3d 159 (April 2004) (en banc). *Arizona Supreme Court Overrules The Court Of Appeals' Narrow Definition For "Machinery Or Equipment"; Supreme Court Adopts A More Flexible Approach That Looks To "The Nature Of The Item And Its Role In The Operations" To Determine Whether An Item Constitutes Exempt "Machinery Or Equipment." As background, in 1998, State ex rel. Arizona Department of Revenue v. Capitol Castings, Inc., 193 Ariz. 89, 970 P.2d 443 (Ct. App. 1998) ("Capitol Castings I") determined that sand, lime, cement, and other materials used to fabricate and operate molds for casting mining equipment did not qualify for the exemption for machinery and equipment used directly in manufacturing, processing, and other activities specified in A.R.S. Section 42-5959(B)(1). Because the materials were consumed in the manufacturing process after only a few uses, the Court held them to be "expendable materials," which in 1998, were expressly excluded from the exemption. In 1999, the Legislature retroactively amended the exemption to provide that the exclusion for "expendable materials" does not apply to items that otherwise constitute machinery or equipment used in manufacturing, processing, or another of the activities specified in Section 42-5959(B)(1). On remand from the 1998 decision, Capitol Castings appealed from the tax court's finding that, while the taxpayer had used the materials to make machinery and equipment that was used directly in manufacturing, the materials themselves were not "machinery" or "equipment" within the meaning of Section 42-5959(B)(1). Embracing the "fixed assets" approach to defining "machinery or equipment" from Capitol Castings I, State ex rel. Arizona Department of Revenue v. Capitol Castings, Inc., 205 Ariz. 258, 69 P.3d 29 (Ct. App. 2003) ("Capitol Castings II"), ruled that the sand, lime, cement, and the other materials themselves are not "machinery or equipment" within the meaning of the exemption. In other words, Capitol Castings II held that component parts of machinery and equipment do not qualify for the exemption.

In the latest decision, the Arizona Supreme Court found two independent grounds to hold that the approach of *Capitol Castings I* and *II* to defining "machinery or equipment" was "too narrow." First, a narrow definition would frustrate the exemption's purpose to stimulate the economy and thereby increase other tax revenues. Second, the language, legislative history, and effective date of the 1999 amendment indicate that the Legislature intended to negate the entire result of *Capitol Castings I* as well as to reinstate "the broader, function-based" tests contained in *Duval Sierrita Corp. v. Arizona Department of Revenue*, 116 Ariz. 200, 568 P.2d 1098 (Ct. App. 1977), which *Capitol Castings I* had distinguished. Rather, the Supreme Court requires courts to "apply flexible

and commonly used definitions of machinery and equipment within the relevant industry." To determine whether an item qualifies as "machinery or equipment," a court must also look to a) how "essential or necessary" an item is "to the completion of a finished product" and b) how prominent a role the item has "in maintaining a harmonious integrated synchronized system." Relevant factors for these inquiries include whether the item in question is in physical contact with raw materials or the work in process, whether the item somehow manipulates or has some other effect upon raw materials, and whether the item adds value to the finished product "as opposed to simply reducing costs or relating to post-production activities." The Supreme Court held that sand, chemical binders, exothermic sleeves, mold cores, mold wash, and mold topping powder qualified as machinery and equipment because they were integral parts of and had a close nexus to the casting process. As an aside, the Court concluded that cement and lime used to neutralize toxic fumes generated during the casting process, however, did not qualify because they were used in an ancillary process for the control of pollution and, therefore, were not integral to the casting process.

DEPARTMENT OF REVENUE RULINGS AND DECISIONS

Arizona Transaction Privilege Tax Ruling 04-01 (***Mobile Telecommunications Services*****)** covers in detail the sales taxation of mobile telecommunications services. It provides that mobile telecommunications services include both one-way and two-way wireless communications carried on between mobile stations or receivers and land stations, and by mobile stations communicating among themselves. Mobile telecommunications may include, but are not limited to, wireless local and interstate telephone service, paging services, two-way radio service, directory information, call forwarding, caller identification, call-waiting, broadband personal communication services, wireless radio telephone services, geographic-area specialized and enhanced specialized mobile radio services, and incumbent-wide area specialized mobile radio licensees. The ruling also indicates that Arizona follows the Mobile Telecommunications Sourcing Act and pursuant to the MTSA, Arizona taxes intrastate mobile telecommunications services according to the customer's place of primary use, which is the customer's residential street address or primary business street address.

Arizona Transaction Privilege Tax Ruling 03-1 (***Sales of Autos to Non-Residents)*** clarifies the requirements for exemption from retail sales tax under A.R.S. § 42-5061(A)(28), which exempts the sale of a motor vehicle to nonresidents when the purchaser's state of residence does not allow a credit against sales or use tax owed on the purchase. Nonresidents purchasing motor vehicles must, in addition to obtaining a special thirty-day nonresident registration, complete a Transaction Privilege Tax Exemption Certificate, Form 5000. Nonresidents from states that allow a credit for Arizona sales tax are not exempt from Arizona sales tax. TPR 03-1 also clarifies the exemption from retail sales tax under A.R.S. § 42-5061(A)(14) for nonresidents purchasing motor vehicles that are shipped or delivered out of state by the vendor for use outside the state. The exemption does not apply to part-year residents nor to nonresident military personnel purchasing vehicles for use in Arizona during the military assignment. Registration in Arizona within three months will result in a presumption that the vehicle was purchased for use in Arizona. Arizona Form 5010, *Certificate of Delivery Out of State*, is the appropriate exemption certificate that automobile dealers are required to secure from purchasers claiming exemption under section 42-5061(A)(14).

Arizona Transaction Privilege Tax Ruling 03-2 (***Motor Carrier Tax Exemption - Trailers and Semi-Trailers)*** clarifies the application of the exemption for leasing or renting a motor vehicle with a gross vehicle weight in excess of twelve-thousand (12,000) pounds where the motor carrier fee is paid, whether by the owner, lessee or authorized third party, on the specific vehicle that is leased, including vehicles

registered as an apportioned vehicle. Trailers and semi-trailers leased independently for use in a vehicle combination are not subject to privilege tax if the motor carrier fee has been paid on the power unit towing the trailer and the power unit is registered as a vehicle combination. Furthermore, the exemption from retail sales tax applies to the sale of a motor vehicle, trailers and semi-trailers that constitute a vehicle combination and repair and replacement parts sold to a person engaged in leasing vehicles.

Arizona Transaction Privilege Tax Ruling 03-3 (***Motor Carrier Tax Exemption - One Way Fleet)*** provides that leasing or renting a truck less than twenty-six thousand (26,000) pounds gross vehicle weight that is operated as part of an identifiable one-way fleet and registered on an allocated basis is not subject to privilege tax regardless of the state in which the vehicle is registered. An exemption from retail sales tax also applies to the sale of motor vehicles including any repair and replacement parts sold to a person engaged in leasing such trucks.

Arizona Transaction Privilege Tax Ruling 03-4 (***Motor Carrier Tax Exemption - Payment on Apportioned or Allocated Basis)*** provides that leasing or renting a motor vehicle to a person engaged in an activity subject to the transporting classification is exempt from privilege tax provided the motor carrier fee on the vehicles has been paid. The motor carrier fee may be paid in full, on an apportioned basis, or paid on allocated basis if the vehicle is part of a one way fleet. The lessee's income from operating such vehicles is also exempt from privilege tax.

Arizona Transaction Privilege Tax Ruling 03-5 (***Sales of Books to Libraries)*** clarifies the exemption from retail sales tax for printed, photographic, electronic and digital media sold to public libraries for public use by providing examples of items that qualify for the exemption (such as books, magazines, videos, audio CDs, and educational software that are intended for use by library patrons) and items that are taxable (such as projection equipment, video players, computers, security devices, and various office supply items).

[There was no TPR 03-6 issued.]

Arizona Transaction Privilege Tax Ruling 03-7 ***(Long-Term Lease of Autos)*** provides that while a person engaged in the business of leasing automobiles on a long-term basis is subject to tax under the personal property rental classification, the tax base does not include reimbursements by the lessee for payments made by the lessor for vehicle title and registration fees, license plate fees, and vehicle license tax, if these amounts are separately identified and billed to the lessee. The ruling also provides that in addition to the lease payments, an automobile dealer or lessor is subject to tax on amounts received as a capitalized cost reduction or as lease termination charges. The ruling provides that the taxable capitalized cost reduction includes any cash payment, manufacturer's rebate, credit card bonus, or any other item for which credit is given to the lessee. It also provides that the amount of credit allowed for a vehicle that was traded in on the leased vehicle is not subject to tax. Lease termination charges, which are taxable, include, but are not limited to, an early termination fee, excessive mileage charge, or excessive wear and tear charge.

TRANSACTION PRIVILEGE TAX PROCEDURES

Transaction Privilege Tax Procedure 04-1 (*Refund Procedure for "Lemons")* provides the procedures for claimants requesting a refund of transaction privilege taxes paid that is available under the provisions of House Bill 2086 (Laws 2004, Chap. 242) which provided a refund to motor vehicle manufacturers who repurchase motor vehicles pursuant to Arizona's "lemon law" statutes.

Transaction Privilege Tax Procedure 04-2 (*Refund Procedure for Design and Engineering)* provides guidance to taxpayers requesting a refund of transaction privilege taxes paid on design and engineering

fees under the prime contracting classification that is available under the retroactive provisions under Senate Bill 1293 (Laws 2004, Chap. 309). The procedure provided that any claims needed to be filed by December 31, 2004. The legislation was retroactive to tax periods beginning from and after October 17, 1969 (which was the date of the Supreme Court's decision in the *Ebasco* case). Naturally, the statute of limitations for refund claims on periods back to 1969 have long closed. This ruling provides the details on how to file refund claims for those closed periods. It seems to be the Department's position, although not supported by the legislation itself, that any refund claims for design and engineering fees, whether for periods that are currently open or closed and back to 1969, have to be filed by December 31, 2004. However, we believe that the legislative intent was that the retroactive refund provision and the legislative requirement to file refund claims by December 31, 2004 applies only to periods that were closed at the time that the legislation became effective in August, 2004. The statutory period for filing refund claims is four years and if a taxpayer paid tax on design and engineering fees under the contracting classification for open periods, say back to the year 2001, a refund claim could be filed under the normal refund statutory limitations period without having to be filed by December 31, 2004 and also not subject to the $100,000 aggregate refund cap limitation provided by the legislation for retroactive refund claims.

DECISIONS OF THE DIRECTOR

Transaction Privilege Tax Decisions

CASE NO. 200300086-S (*Home Electric Generators Not Exempt)* (March 19, 2004) held that the sale of small electric generators for household and farm use by a retailer were not exempt from the transaction privilege tax. A.R.S. § 42-5061(B)(4) provides an exemption for machinery, equipment, or transmission lines used directly in producing or transmitting electrical power, but not including distribution. The taxpayer argued that the generators in question should qualify under that exemption. The Director concluded that the exemption is intended for sales made to electric utility companies because their sales of electricity produced are in turn subject to the transaction privilege tax and that the exemption was thus not intended to apply to sales made for household and farm use.

CASE NO. 200200180-S (*Design and Engineering Fees Taxable)* (November 26, 2003) held that architectural, engineering and design fees were taxable under the prime contracting classification although separately stated in the construction contract and separately billed. It should be noted that this decision has been overruled by legislation -- Senate Bill 1293, Laws 2004, Chapter 309 (amending A.R.S. § 42-5075.J).

CASE NO. 200200148-S (*Non-Alcoholic Beer and Wine Not Exempt Food)* (August 25, 2003) held that beer and wine labeled as non-alcoholic, but which contained less than one-half of 1% alcohol, constitutes alcoholic beverages and do not fall within the definition of food eligible to be sold by a qualified retailer exempt from the transaction privilege tax.

CASE NO. 200200106-S (*Confusion is not Reasonable Cause)* (March 6, 2003) held that a taxpayer did not present reasonable cause for the abatement of penalties. The taxpayer built townhouses. The Department audited the taxpayer and assessed transaction privilege tax under the contracting classification along with penalties and interest. The taxpayer accepted the audited tax liability but protested the assessment of penalties and interest. The taxpayer testified that it had been confused as to the tax liability between it and its affiliated development company and after it realized its error, filed late and amended tax returns. The Director held that the taxpayer's actions were not reasonable and did not abate penalties or interest. It should be noted that while penalties can be abated for reasonable cause, interest cannot be abated unless the taxpayer relied upon erroneous written advice from the Department, which was not the case here.