CONSUMER'S USE TAX ON OUT-OF-STATE PURCHASES

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Prepared for
National Business Institute:
Reducing Your Clients' Sales and
Use Tax Obligations in Arizona Seminar
Wednesday, June 1, 2005
Phoenix, Arizona

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Washington, D.C. *Phoenix* *Los Angeles* *London* *Brussels* *New York*

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1. *PURPOSE OF THE USE TAX.*

The Arizona Legislature enacted the use tax in 1955 and it took effect on July 1, 1956. The then Governor of Arizona, Earnest W. McFarland, called a special session of the legislature to enact the tax to protect local retailers from residents going out of state to make their purchases free of the sales tax. The Governor's comments calling a special session summarized the purpose of the tax:

> In the First Regular Session of the Legislature, I recommended to you the enactment of a use tax. As I pointed out to you in my message at that time, I do not consider this an additional tax but merely an equalization of taxes. The people who sell goods in this State should be protected from inequities which result without a use tax. The businessmen not only have to pay a tax on the goods they sell, but they also have to pay ad valorem and state income taxes. Enactment of the use tax would, therefore, serve a double purpose; the protection of industry in our state and the raising of revenue to take the place of that lost by the repeal of the tax on sales to the federal government.
>
> The use tax itself would not only increase the revenues from goods purchased outside the State; but would have a wholesome effect on the local industry of our State by encouraging our people to trade at home.

Ariz. Sess. Laws 1955, 2nd S.S., Ch. 1, § 3.

In *People of Faith, Inc. v. Ariz. Dep't of Reve.*, 161 Ariz. 514, 779 P.2d 829 (Tax Ct. 1989), 171 Ariz. 140, 829 P.2d 330 (App. 1992), the Arizona Tax Court detailed the nature of the use tax:

> Use taxes, sometimes otherwise labeled, came into being to inhibit buyers from avoiding sales taxes by making purchases out-of-state. [citations omitted] The difference between sales and use taxes is sometimes defined by describing sales taxes as being imposed on transactions within a state, and use taxes as being imposed on transactions consummated out-of-state. [citations omitted]
>
> Typically sales taxes and use taxes are complementary. [citations omitted] Both taxes start with a retail sale. The sales tax is a transaction tax on the sale. It is imposed upon the seller but ordinarily is passed through to the buyer. The use tax is a tax on the privilege of using the purchased property within the state and is imposed upon the buyer. Both taxes are computed by multiplying the sales price by the tax rate. To be truly complementary, both taxes should be at the same rate. If the sale was subject to sales tax, the buyer is exempt from use tax. [citations omitted]
>
> If the foregoing scheme works as it is designed to work, the buyer (the real payer of the sales tax, whether passed through or not) pays one tax or the other on retail purchases, regardless of where the purchase is made. If all retail sales within a state are subject to a sales tax, then, because the buyer is exempt from use taxes on such sales, use taxes can only be imposed on the use of property purchased outside the state.

161 Ariz. at 517, 779 P.2d at 832.

Use Tax Is Complement To Sales Tax. The use tax is the complement or back-up to the sales tax, with the sales tax imposed on the retail sale of property within Arizona and the use tax imposed on a purchaser who purchases property from an out-of-state retailer and brings it into Arizona and uses it here.

2. *THE "INCIDENT"* OR FOCUS OF THE USE TAX.

Arizona's use tax is an excise tax on "the storage, use or consumption in this state of tangible personal property purchased from a retailer or utility business." A.R.S. § 42-5155.A. In contrast to Arizona's sales tax, the liability for which is imposed on the seller, the use tax is imposed on the purchaser; i.e., the "person storing, using or consuming in this state tangible personal property purchased from a retailer or utility business." A.R.S. § 42-5155.D.

The key words are "retailer," "storage," "use" or "consumption," which are defined by A.R.S. § 42-5701 as follows:

"*Retailer*" includes:

> Every person engaged in the business of making sales of tangible personal property for storage, use or other consumption or in the business of making sales at auction of tangible personal property owned by that person or others for storage, use or other consumption. If in the opinion of the department it is necessary for the efficient administration of this article to regard any salesmen, representatives, peddlers or

canvassers as the agents of the dealers, distributors, supervisors or employers under whom they operate or from whom they obtain the tangible personal property sold by them, regardless of whether they are making sales on their own behalf or on behalf of such dealers, distributors, supervisors or employers, the department may so regard them and may regard the dealers, distributors, supervisors or employers as retailers for purposes of this article.

(a) A person who solicits orders for tangible personal property by mail if the solicitations are substantial and recurring or if the retailer benefits from any banking, financing, debt collection, telecommunication, television shopping system, cable, optic, microwave or other communication system or marketing activities occurring in this state or benefits from the location in this state of authorized installation, servicing or repair facilities.

"*Storage"* means keeping or retaining tangible personal property purchased from a retailer for any purpose except sale in the regular course of business or subsequent use solely outside this state.

"Use or consumption" means the exercise of any right or power over tangible personal property incidental to owning the property except holding for sale or selling the property in the regular course of business.

The use tax usually arises in the context of an interstate sale. If neither the "selling state" nor the "buying state" have sufficient nexus with a transaction to impose their respective sales taxes, as is often the case in an interstate sales transaction, purchasers could buy goods from out-of-state sellers free of sales tax. The use tax plugs this potential loophole.

3. *DIFFERENCES BETWEEN SALES TAX AND USE TAX.*

The sales tax is imposed on sales made by vendors located in Arizona, while the use tax is levied on out-of-state vendors. Since the sales tax and the use tax are complementary taxes, only one of the taxes can be applied to a given transaction. *See* AAC R15-5-2306.

4. *WHEN A TRANSACTION IS SUBJECT TO THE SALES TAX.*

Sales made by vendors maintaining a place of business within Arizona are subject to the sales tax. Sellers operating from a commercial location or other point of distribution, soliciting from a public place of business, or buying and selling articles on their own account within the state are deemed to be in the business in Arizona.

For example, an office equipment dealer maintains a sales office in Arizona, solicits business from customers in Arizona, and orders the equipment from its home office out-of-state. Although the seller maintains no stock of inventory in Arizona and the products are shipped directly to the purchaser, the seller is nevertheless considered to be engaging in business within Arizona. Such sales are taxable under the sales tax statutes. *See* AAC R15-5-2307.

5. *WHEN A TRANSACTION IS SUBJECT TO THE USE TAX.*

Purchases made from vendors not maintaining a place of business in Arizona to Arizona customers are subject to the use tax. For example, purchases from an out-of-state vendor selling by mail order to Arizona residents are subject to the use tax. *See* AAC R15-5-2308.

6. ***PRESUMPTION OF THE TAXABILITY OF PROPERTY BROUGHT INTO STATE.***

It is presumed that tangible personal property purchased by any person and brought into Arizona is purchased for storage, use or consumption here. A.R.S. § 42-5152.

The regulations amplify on this and provide that if tangible personal property is purchased outside Arizona and is subsequently brought into Arizona for use, storage or consumption, the purchaser is subject to the use tax unless the purchaser establishes to the satisfaction of the Department:

(1) That the property is not used in conducting a business in Arizona; and

(2) That the property was purchased for bona fide use or consumption outside Arizona. Unless shown otherwise, it is presumed that the property was purchased for bona fide use or consumption outside Arizona if it was purchased at least 3 months prior to its initial entry into Arizona; or

(3) If the property was purchased by a non-resident, that the first actual use or consumption of the property occurred outside Arizona. *See* AAC R15-5-2304.

7. ***THE STORAGE, USE OR CONSUMPTION MUST BE IN ARIZONA.***

The storage or use or consumption must be within Arizona. In *Service Merchandise Co., Inc. v. Ariz. Dep't of Rev.*, 188 Ariz. 414, 937 P.2d 336 (Ct. App. 1996), the Arizona Court of Appeals held than an out-of-state retailer was subject to use tax on its catalogs and fliers that it had delivered or mailed into Arizona from outside the state. The court reasoned that "distribution" was use in the state.

8. ***PROPERTY HELD FOR SALE OR LEASE OR STORED FOR LATER USE OUTSIDE THE STATE IS NOT TAXABLE.***

Both the definition of storage and use or consumption contain exceptions for holding property for sale in the regular course of the taxpayer's business. In the case of storage, there is also an exception for property that will be subsequently used outside of Arizona. *See* A.R.S. § 42-5701.

Purchases of tangible personal property from a retailer for subsequent leasing or renting in the ordinary course of the purchaser's business are also not subject to the use tax. *See* AAC R15-5-2309.

9. ***USE TAX RATE.***

State – 5.6 % (5% prior to June 1, 2001)
County - None
Cities - Varies

The state use tax rate is 5.6 percent (5%). Some cities also impose use tax and most of the larger cities license and collect the use tax independently from the state. For information regarding those cities and the applicable use tax rates, consult the Model City Tax Code. There is no county use tax.

10. ***LICENSING AND PAYMENT.***

Persons who currently have a transaction privilege tax license do not need a separate state license for state use tax purposes. Such persons can report state use tax by using their state transaction privilege tax license number and reporting the use tax on the Transaction Privilege, Use and Severance Tax Return, Form TPT-1.

Persons who do not have a transaction privilege tax license, but who make frequent purchases from out-of-state retailers who are not registered to collect use tax, should themselves register with the Department for use tax purposes. Any use tax due would then be reported on the same Form TPT-1 using the use tax license number.

For city use tax licensing and payment procedures, consult the Model City Tax Code.

11. ***USE TAX DOES NOT APPLY TO IN-STATE PURCHASES.***

A.R.S. § 42-5159.A.1 exempts from the use tax "tangible personal property sold in this state, the gross receipts from the sale of which are included in the measure of the tax imposed by article 1 and 2 of this chapter [the transaction privilege tax]." In *People of Faith v. Arizona Dep't of Revenue*, 161 Ariz. 514, 779 P.2d 829 (Tax Ct. 1989), the Tax Court interpreted the words "included in the measure of the tax" as:

> those sales on the gross receipts of which the seller is obligated … to pay a [sales] tax; except those sales which, because of some act on the part of the buyer, the seller reasonably believes, at the time of the sale, are exempt from the application of the [sales] tax … .

The Tax Court thus held that the use tax is not applicable to in-state purchases except in those instances where the buyer has provided the seller an erroneous exemption certificate or otherwise has misled the seller into thinking that the transaction was exempt from the sales tax.

12. ***CREDIT FOR SALE S TAXES PAID IN STATE OF PURCHASE.***

When a sales tax has been paid in the state of purchase equal to or greater than the Arizona use tax rate of 5.6%, the purchaser has no further liability. In cases where the amount of sales tax paid and the state of purchase is less than the Arizona use tax, the purchaser has an additional liability to Arizona. For example, if the amount of tax paid in another state is 3% of the purchaser price and the Arizona use tax rate is 5.6%, the purchaser is required to pay an additional 2.6%. *See* AAC R15-5-2305.

13. ***EXEMPTION FOR CASUAL SALES.***

Tangible personal property purchased in a casual sale, and not from a retailer, is not subject to the use tax. *See* AAC R15-5-2312. A "casual sale" is "an occasional transaction of an isolated nature made by a person who is not engaged in the business of selling, within or without the State of Arizona, the same type or character of property as that which was sold. *See* AAC R15-5-2001. Thus, if an Arizona business purchases a piece of machinery from an out-of-state manufacturer that was using the machinery in its manufacturing operations but no longer needs it, the use tax would not apply because it would be a casual transaction (assuming that the out-of-state manufacturer does not regularly engaged in the business of selling that type of equipment).

14. ***LEASE – PURCHASE ARRANGEMENTS.***

Purchase payments made after conversion from a lease to a purchase of tangible personal property is subject to the use tax unless the lease–purchase transaction was subject to the sales tax at its inception. This would apply to the situation where the lessor is an out-of-state lessor. If the lessor were in-state lessor, then the sales tax would apply on the conversion from a lease to a purchase. Additionally, the purchase price includes conversion charges paid or incurred at the time the lease is converted to a purchase. *See* AAC R15-5-2313.

15. *PURCHASES FROM TRUSTEES, RECEIVERS AND ASSIGNEES.*

Tangible personal property purchased for storage, use or consumption in Arizona from a trustee, receiver or assignee is subject to the use tax if the purchase of the tangible personal property in the hands of the owner would have been subject to the use tax. In other words if the owner were a "retailer" then the use tax would apply. Otherwise, the transaction would be a casual, non-taxable transaction. *See* AAC R15-5-2314.

16. *MACHINERY AND EQUIPMENT EXEMPTION.*

The machinery and equipment exemption equally applies to use tax purchases. *See* AAC R15-5-2320.

17. *ARTICLES TO BE INCORPORATED INTO A MANUFACTURED PRODUCT.*

Purchases of articles which become an integral part of a manufactured product are not subject to the use tax but are considered purchases for resale. *See* AAC R15-5-2321.

18. *MANUFACTURING LABOR.*

The cost of labor employed in the manufacturing, processing or fabricating of tangible personal property is not allowed as a deduction from the sales price on the purchase of such property. *See* AAC R15-5-2326.

19. *FUELS.*

"Use fuel" is fuel other than motor vehicle fuel as defined in A.R.S. § 28-101(28). Diesel fuel is a use fuel. Gasoline is a motor vehicle fuel.

Purchases of use fuel are taxable if the use fuel is *not* used to propel vehicles on the streets, roads or highways in Arizona. Purchases of jet fuel are subject to tax under the jet fuel excise and use tax classification (which is separate from the normal use tax).

20. *DELIVERY CHARGES.*

A charge by a retailer for delivery from the retailer's location to the purchaser's location, as separately stated on the sales invoice, is not subject to the use tax. *See* AAC R15-5-2332. Conversely, delivery charges, from the manufacturer to the retailer are <u>not</u> deductible.

21. *PURCHASES OF RESTAURANT ACCESSORIES ("PAPER PRODUCTS").*

Purchases of disposable containers, paper napkins and other summer food accessories by persons engaged in the restaurant business that are transferred by the restaurant in the regular course of business to facilitate the consumption of the food, drink or condiment provided are considered purchases for resale. *See* AAC R15-5-2334.A.

Purchases and matchbooks, advertising fliers and summer tangible personal property by persons engaged in the restaurant business that are transferred by the restaurant for the convenience, operation or benefit of the restaurant business are taxable. *See* AAC R15-5-2334.B.

22. *COMPUTER HARDWARE AND SOFTWARE.*

Purchases of computer hardware are subject to the use tax, unless the computer hardware otherwise qualifies for exemption, such as the manufacturing machinery and equipment exemption. Custom software is not taxable. Off the shelf software is subject to the use tax. *See* AAC R15-5-2342 and AAC R15-5-154.

23. *PURCHASES BY NON-RESIDENTS; 3 MONTH PRESUMPTION.*

Tangible personal property brought into Arizona by a non-resident to be used in business in Arizona is subject to the use tax.

Tangible personal property brought into Arizona for use by a non-resident temporarily within Arizona is not subject to the use tax if the property is for the personal use of the non-resident and is taken out of the state when the non-resident leaves Arizona.

If tangible personal property is purchased outside Arizona and is subsequently brought into the state for use, storage or consumption, the purchaser is subject to the Arizona use tax unless the purchaser establishes to the satisfaction of the Department:

1. That the property is not used in conducting a business in Arizona; and

2. That the property was purchased for bona fide use for consumption outside Arizona. Unless it can be otherwise shown, it is presumed that the property was purchase for bona fide use or consumption outside of Arizona if the property was purchased at least 3 months prior to its initial entry into Arizona; or

3. If the property was purchased by a non-resident individual that the first actual use or consumption of the property occurred outside Arizona.

See AAC R15-5-2352.

24. *PROPERTY PURCHASED OUTSIDE OF THE UNITED STATES; $200/MONTH EXEMPTION.*

Tangible personal property purchased outside the United States is taxable when purchased for business use. In anyone calendar month, tangible personal property purchases with a cumulative purchase price of $200 or less are not taxable if purchased for non-business use. Purchases in excess of the $200 exemption are taxable on the excess amount. *See* AAC R15-5-2353.

25. *PURCHASERS LIABILITY FOR PROVIDING FALSE EXEMPTION CERTIFICATE OR OTHERWISE MISLEADING SELLER.*

If a purchaser provides a seller with an exemption certificate which is false, or otherwise provides misleading information concerning the purchaser's entitlement to an exemption to the seller, there is a statutory provision which will allow the Department of Revenue to go to the purchaser and require the purchaser to prove its entitlement to the exemption. If the purchaser cannot, then the purchaser is liable for the tax, penalty and interest. *See* A.R.S. §§ 42-5009.D and E.

26. *APPLICABILITY OF USE TAX TO MOTOR VEHICLES.*

Motor Vehicles Removed from Inventory. A.R.S. § 42-5157 provides that the use tax that is imposed on motor vehicles removed from the inventory of a dealer as defined in § 28-1301, that are used directly in the conduct of the motor vehicle dealer's primary business and are returned to the dealer's active sales inventory within one year after the date of the initial removal from inventory is to be levied and imposed on a monthly basis and applied to one thirty-ninth ($1/39^{th}$) of the value of each new motor vehicle as determined by the manufacturer's suggested retail price and to $1/39^{th}$ of the value of each used motor vehicle as determined by any industry-wide publication and common use and devoted to listing used care values.

Exemption for Cars Donated to Charity. A.R.S. § 42-5159.A.32 exempts motor vehicles that are removed from inventory by a motor vehicle dealer, as defined in § 28-1301, and provided to charitable institutions exempt from taxation under § 501(c)(3) of the Internal Revenue Code.

Use Tax on Manufacturers' Automobiles. The use tax imposed on a motor vehicle manufacturer for the storage, use or consumption of its maintenance, support or service motor vehicles is imposed on a monthly basis and is applied as a percentage of one thirty-ninth of the dealer net price of the motor vehicles. This tax is not to be imposed for more than 39 months on any motor vehicle. Motor vehicles and component parts used in any manner for testing or development by a motor vehicle manufacturers are not subject to the use tax. This provision is retroactively effective to taxable periods beginning from and after December 31, 1992. A.R.S. § 42-5158.

27. *EXEMPTIONS.*

The use tax exemptions are not identical with the sales tax exemptions. There are some sales tax exemptions which are not carried over to the use tax exemption statute and there are use tax exemptions in addition to the various sales tax exemptions. Following is a summary listing of all of the use tax exemptions. *See* A.R.S. § 42-5159.A.

1. Tangible personal property sold in Arizona, the gross receipts from which are included in the measure of the sales tax.

2. Tangible personal property, the sale or use of which has already been subjected to an excise tax equal to or in excess of the Arizona use tax under the laws of some other state.

3. Tangible personal property, the storage, use or consumption of which the constitution or laws of the United States prohibit Arizona from taxing.

4. Tangible personal property which becomes an ingredient or component part of any manufactured, fabricating or processed article, substance or commodity for sale in the regular course of business.

5. Motor vehicle fuel; and use fuel, the sales, distribution or use of which in Arizona is subject to the gasoline tax, and aviation fuel and jet fuel which are subject to the aviation fuel and just fuel taxes.

6. Tangible personal brought into Arizona by an individual, who is a non-resident at the time the property was purchased, if the first actual use or consumption of the property was outside Arizona, unless that property is used in conducting a business in Arizona.

7. Implants used as growth promotants and injectable medicines not otherwise exempt for livestock and poultry.

8. Livestock, poultry, feed, salts, vitamins and other additives for use in the businesses of farming, ranching and feeding livestock or poultry (fertilizers, herbicides and insecticides are excluded).

9. Seeds, seedlings, roots, bulbs, cuttings and other propagative material used in commercially producing agricultural, viticultural or floracultural crops in Arizona.

10. Tangible personal property not exceeding $200 in any one month purchased by an individual at retail outside the continental limits of the United States for the individual's own personal use and enjoyment.

11. Advertising supplements which are intended for sale with newspapers published in Arizona and which have been subject to an excise tax under the laws of another state, which equals or exceeds the Arizona use tax right.

12. Sales of printed, photographic, electronic or digital materials to public libraries.

13. Tangible personal property purchased by any of the following:

(a) A charitable hospital.

(b) A governmental hospital.

(c) A licensed nursing care institution, license residential care institution, residential care facility operated in conjunction with a licensed nursing care institution, or a licensed kidney dialysis center.

(d) A qualifying healthcare organization as defined in § 42-5001 if the tangible personal property is used solely to provide health and medical related educational and charitable services.

(e) A qualifying healthcare organization dedicated to providing educational, therapeutic, rehabilitative and family medical education training for blind, visually impaired and multi-handicapped children up to the age of 21.

(f) A 501(c)(3) charitable organization that uses the property exclusively for training, job placement or rehabilitation programs or testing for mentally or physically handicapped persons.

(g) A contractor or subcontractor if the tangible personal property (building materials) is incorporated into a construction project, used in environmental response or remediation activities, or incorporated into a lake facility development (i.e., Tempe Town Lake).

(h) A 501(c)(3) charitable organization if the property is purchased from the parent or an affiliate organization that is located outside of Arizona.

(i) A qualifying community health center as defined in § 42-5001.

(j) A 501(c)(3) charitable organization that regularly provides free meals to the needy and indigent on a continuing basis.

(k) A hotel or motel if the property is a personal hygiene product which is furnished without additional charge to the guests (shampoos, soaps, etc.).

(l) After June 30, 2001, a 501(c)(3) charitable organization that produces residential apartment housing for low income persons over 62 years of age in a facility that qualifies a federal housing subsidy.

14. Sales of commodities consigned for resale in a warehouse in Arizona.

15. Tangible personal property sold by:

(a) A 501(c)(3) charitable organization.

(b) A 501(c)(3), 501(c)(4), 501(c)(6), 501(c)(7) or 501(c)(8) organization which sponsors or operates a rodeo featuring primarily farm and ranch animals.

16. Prescription drugs and medical oxygen.

17. Prosthetic appliances.

18. Prescription eyeglasses.

19. Insulin, syringes and glucose test strips.

20. Hearing aids.

21. Durable medical equipment.

22. Food for home consumption.

23. Items purchased with food stamps.

24. Food and drink provided without charge by a restaurant to its employees for their consumption on the premises during the employees' hours of employment.

25. Tangible personal property that is used or consumed by a restaurant for human food, drink or condiment.

26. Food, drink or condiments used by public schools for serving in school cafeterias.

27. Lottery tickets.

28. Textbooks sold by a bookstore that are required by any state university or community college.

29. Magazines and other periodicals or publications produced by the State of Arizona to encourage tourist travel (the *Arizona Highways Magazine*).

30. Paper machine clothing, such as forming fabrics and dryer felts, purchased by a paper manufacturer and used in paper manufacturing.

31. Coal, petroleum, coke, natural gas, virgin fuel oil and electricity sold to an environmental technology manufacturer.

32. Motor vehicles removed from the inventory of a dealer and provided to charitable or educational institutions, public educational institutions, or state universities.

33. Natural or liquefied petroleum gas for a motor vehicle.

34. Machinery, equipment or technology to assist a person who has a developmental disability or a head injury.

35. Chemicals used in manufacturing, processing, fabricating, mining, refining, metallurgical operations, research and development and printing if the chemicals come in contact with the materials being produced and cause a physical change to incur in those materials.

36. Food, drink and condiment purchased or consumption in any prison, jail or other corrective institution.

37. Motor vehicles and repair parts sold to a motor carrier who has paid the motor carrier tax and leases motor vehicles.

38. Tangible personal property which becomes an ingredient or component part of cards used as prescription plan identification cards.

39. Certain overhead materials used in performing a federal contract by a manufacturer, modifier, assembler or repairer.

40. Until December 31, 1994, personal property sold pursuant to a personal property liquidation transaction.

41. Wireless telecommunications equipment (cell phones) that are held for sale or transferred to a customer as an inducement to enter into or continue a contract for telecommunications services.

42. Sales of alternative fuel to a used oil fuel burner.

43. Food and beverages sold to an airline for consumption in flight.

44. New alternative fuel vehicles.

45. Natural or artificial gas diverted from a pipeline to be used for the sole purpose of fueling compressor equipment that pressurizes the pipeline.

46. Electricity, gas and water sales which are otherwise exempt under the utilities classification of A.R.S. § 42-5063 (e.g., sales to qualifying hospitals, qualifying healthcare organizations, sales to environmental technology manufacturers).

47. Tangible personal property used as a part of an environmental response or remediation activity under § 42-5075.B.6 (the contracting classification exemption for remediation work).

48. Tangible personal property sold by a non-profit organization that is exempt from taxation under § 501(c)(6) of the internal revenue code if the organization produces, organizes or promotes cultural or civic related festivals or events and no part of the

organization's net earnings inures to the benefit of any private shareholder or individual.

A. *The Machinery and Equipment Exemption.* The use tax has the same exemption for machinery and equipment as the sales tax. See A.R.S. § 42-5159.B**.**

1. Machinery or equipment used directly in manufacturing, processing, fabrication, job printing, refining or metallurgical operations.

2. Mining machinery or equipment used directly in extracting ores or minerals from the earth.

3. Central office switching equipment, switchboards, private branch exchange equipment, microwave radio equipment and carrier equipment sold to telecommunications companies.

4. Machinery or equipment used to generate electrical power and transmission lines.

5. Neat animals, horses, asses.

6. Pipes or valves 4 inches in diameter or larger to transport oil, natural gas, artificial gas, water or coal slurry.

7. Aircraft sold to:

(a) A person holding a federal certificate of public convenience and necessity or foreign air carrier permit.

(b) A foreign government.

(c) Non-residents of this state that will not use the aircraft in this state.

8. Machinery and equipment used in repairing, remodeling or maintaining aircraft.

9. Railroad rolling stock, rails, ties and signal control equipment.

10. Machinery and equipment used directly to drill for oil and gas.

11. Buses and other urban mass transit vehicles

12. Ground water measuring devices.

13. New agricultural machinery and equipment (tractors, tractor-drawn implements, self-powered implements, milking equipment).

14. Machinery or equipment used in research and development.

15. Machinery and equipment used for motion picture production.

16. Direct broadcast satellite television or data transmission equipment.

17. Clean rooms used for manufacturing or research and development of semi-conductor products.

18. Machinery and equipment used directly in the feeding or housing of poultry.

19. Pollution control equipment, and related structural components, used by manufacturers, mines and utilities.

20. Agricultural pollution control equipment.

21. Digital television broadcast machinery or equipment.

B. *The Machinery and Equipment Exemption Does Not Apply to:*

1. Expendable materials but not including any item that is a part of the exempt machinery regardless of its cost or useful life.

2. Janitorial equipment and hand tools.

3. Office equipment, furniture and supplies.

4. Equipment used in selling or distributing activities.

5. Licensed motor vehicles.

6. Shops, buildings, docks, depots and other materials not specifically included as exempt.

7. Motors and pumps used in drip irrigation systems. *See* A.R.S. § 42-5959.C.

C. *Additional Use Tax Exemptions.*

1. Machinery, equipment or materials used to construct a qualified environmental technology manufacturing facility (as defined in § 41-1514.02). A.R.S. § 42-5159.E.1.

2. The purchase of electricity by an environmental technology manufacturer. A.R.S. § 42-5159.E.2.

3. For computing the purchase price of electricity purchased by a retail electric customer from a utility business, the following are deducted:

(1) Fees charged by municipally owned utility to residential and industrial developers if the fees are segregated and used only for capital expansion, system enlargement or debt service. A.R.S. § 42-5159.D.

(2) Reimbursements or contributions to a utility for property and equipment installed to provide utility access for the utility consumer.

28. *CASES.*

Capitol Castings -- Sand Molds Used In One Production Cycle Constitute Exempt Machinery And Equipment (Component Parts Of Machinery And Equipment Qualify For Exemption). The Arizona Supreme Court in *State ex rel. Arizona Department of Revenue v. Capitol Castings, Inc.*, 88 P.3d 159 (Ariz. 2004) (en banc) overruled the Arizona Court of Appeals' narrow definition for "machinery or equipment" for purposes of the exemption from retail sales tax for machinery or equipment used directly in manufacturing, fabricating, or processing activities. Rather, the Arizona Supreme Court adopted 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." 88 P.3d at 165.

As background, in 1998, *State ex rel. Arizona Department of Revenue v. Capitol Castings, Inc.*, 970 P.2d 443 (Ariz. 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 specific in A.R.S. § 42-5959(B)(1). Because the materials were consumed in the manufacturing process after only a few uses, they were "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 § 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 § 42-5959(B)(1). Deciding that appeal, *State ex rel. Arizona Department of Revenue v. Capitol Castings, Inc.*, 69 P.3d 29 (Ariz. Ct. App. 2003) ("*Capitol Castings II"*), held that the 1999 amendment of the exclusion for "expendable materials" did not expand the definition of "machinery or equipment" to include materials that will ultimately become part of machinery or equipment qualifying for exemption. Embracing the "fixed assets" approach to defining "machinery or equipment" from "*Capitol Castings I*, *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 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." 88 P.3d at 165. First, a narrow definition would frustrate the exemption's purpose to stimulate the economy and thereby increase other tax revenues. *Id.* at 162. 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,* 568, P.2d 1098 (Ariz. Ct. App. 1977), which *Capitol Castings I* had distinguished. *Id.* at 162-63. Rather, the Supreme Court requires courts to "apply flexible and commonly used definitions of machinery and equipment within the relevant industry." *Id.* at 164. 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." *Id.* at 165. The Supreme Court decision 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. 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. *Id.*

Diet Supplement. In *Diet Center v. Arizona Dep't of Revenue,* Arizona Board of Tax Appeals, Division 2, No. 655-89-U (October 12, 1989), the Board held that the use tax applied to a diet counseling center's supplements provided to its clients as a part of the overall diet counseling service fee. The Board reasoned that the Diet Center "used or consumed" the supplements when it gave them to its clients.

Newspaper Inserts. In *Mervyn's & Target Stores v. ADOR,* Arizona Board of Tax Appeals Nos. 521-87-U and 522-87U (December 23, 1990), *K-Mart Corp. v. ADOR,* Arizona Board of Tax Appeals No. 732-90U (March 12, 1991). *Montgomery Ward & Co., Inc. v. ADOR,* Arizona Board of Tax Appeals No. 78-890-U (November 5, 1991), retail stores which purchased advertising supplements from out-of-state printers and shipped them directly to Arizona newspapers which inserted them in the papers for circulation were held to be liable for use tax on the supplements. The Board concluded that the retailers caused the advertising supplements to be printed and exercised control over them by contracting with in-state third parties to direct their distribution which constituted a taxable use. The supplements also did not become ingredient or component parts of the newspapers and were not exempt under those respective use tax exemptions. The Board also concluded in *K-Mart, Montgomery Ward* and *Service Merchandise* that there was no equal protection or commerce clause violation when identical supplements would be printed in-state by the distribution newspapers. The taxpayer alleged that this printing would be tax exempt but the Board concluded that it would be subject to tax as job printing. In *Service Merchandise,* the taxpayer also sent numerous catalogs and fliers to customers in Arizona but the Board held that they differed only from the advertising supplements in the manner in which they were delivered to the ultimate user. The Arizona Tax Court upheld the Board's decision in *Mervyn's & Target Stores v. Arizona Dep't of Revenue,* 173 Ariz. 644, 845 P.2d 1139 (1993).

Catalogs. In *Service Merchandise Co., Inc. v. Arizona Dep't of Revenue,* 188 Ariz. 414, 937 P.2d 336 (App. 1996), the Court of Appeals held that an out-of-state company that directed who would mail its catalogs, to whom they would be sent, and how and when they would be sent to Arizona customers, "used" the catalogs in Arizona, and was subject to the Arizona use tax on the cost of printing those catalogs out-of-state. The Court of Appeals came to the same conclusions in *Sharper Image Corp. v. Arizona Dep't of Revenue,* 1 CA-TX 97-0027 (May 5, 1998).

Car Wash Equipment. In *Weico Corp. v. Arizona Dep't of Revenue,* Arizona Board of Tax Appeals No. 768-90-U (July 30, 1991), the taxpayer, a car wash operator, was found liable for use tax on its purchases of equipment used in its car washing business. The taxpayer argued that the purchases of the equipment were exempt from use tax as materials to be used in manufacturing processing or fabricating. Following the decision of *Meredith Corp. v. State Tax Comm'n,* 23 Ariz. App. 152, 531 P.2d 197 (1975) (video recorder used by TV station is not "processing equipment"), the Board concluded that a common sense approach to the application of the terms manufacturing and processing was required. Consequently, it determined that people did not take cars to a car wash to have them manufactured or processed. The Board had also previously defined processing as an integrated series of operations which transformed tangible personal property into a different product. Based on this reasoning, the Board held that the car wash equipment did not fall under the manufacturing or processing use tax exemptions.

Credit Card Blanks. In *PCS, Inc. v. Arizona Dep't of Revenue,* 176 Ariz. 628, 863 P.2d 920 (1993), the Arizona Tax Court held that "credit card" type of blanks temporarily stored in Arizona, embossed and then shipped to out-of-state cardholders were subject to the Arizona use tax. The Court of Appeals affirmed the tax court's decision. *See* 186 Ariz. 539, 925 P.2d 680 (App. 1995). The tax court's decision was effectively overruled by the Arizona legislature in 1994 when it enacted a specific exemption from the use tax for those types of cards, effective July 17, 1994. *See* Laws 1994, Chapter 305, SB 1301, and A.R.S. § 42-1409.A.35.

Overhead Items Allocated to Federal Contracts Not Subject to the Use Tax; Such Items Were Resold to Federal Government. Motorola Inc. v. Arizona Dep't of Revenue, 229 Ariz. Adv. Rptr. 59 (7/13/99). The Department asserted a use tax assessment against Motorola's purchases of overhead items allocated to federal contracts. The Department argued that the use tax applied to the overhead materials because Motorola "used" those materials in carrying out its contracts with the federal government. The court simplified its analysis by examining the contracts to determine

whether title to the overhead materials passed from Motorola to the United States government. If title passed, then those items were purchased by Motorola for resale to the U.S. government and would not be subject to the use tax. The court examined the contracts, both cost plus contracts and fixed-price contracts and determined that the title passing provisions in each applied to the overhead materials. The court's decision was based on the resale exception to the use tax, which excepts "holding for sale or selling the property in the regular course of business." *See* A.R.S. § 42-5151(12).

Catalogs Printed Out-of-State Subject to Use Tax. Sharper Image Corp. v. Arizona Dep't of Revenue, 1 CA-TX 97-0017 (5/5/98). In *Service Merchandise Co. v. Arizona Dep't of Revenue*, 226 Ariz. Adv. Rptr. 45 (App. 1996), the Court of Appeals held than an out-of state company that directed who would mail its catalogs, to whom they would be sent, and how and when they would be sent to Arizona customers, and "used" the catalogs in Arizona, would be subject to the Arizona use tax on the cost of printing those catalogs out-of-state. The Court of Appeals came to the same conclusion in the *Sharper Image* case. A recent trend of other state appellate courts is to also find that such catalogs printed out-of-state and distributed in-state are "used" in-state and subject to that state's use tax.

Out-of-State Furniture Manufacturer that Delivered and Installed Custom Workstations for a Phoenix Customer Has Sufficient Nexus for Imposition of Arizona's Transaction Privilege (Sales) Tax. Arizona Dep't of Revenue v. O'Connor, Cavanagh, Anderson, Killingsworth & Beshears, P.A., 259 Ariz. Adv. Rptr. 36 (App. 12/23/97). The Phoenix law firm of O'Connor, Cavanagh moved into new office space and contracted with Dunbar Furniture, an out-of-state furniture manufacturer, to manufacture and install is custom secretarial workstations and other furniture. The furniture was all manufactured out-of-state, delivered to O'Connor, Cavanagh's new offices in Phoenix, and installed there. The Department of Revenue audited O'Connor, Cavanagh and imposed a use tax on the cost of those out-of-state furniture purchases. O'Connor took the position that the out-of-state furniture company had sufficient nexus with Arizona to require Arizona to collect the transaction privilege (sales) tax from Dunbar, and not the use tax from O'Connor, Cavanagh. The use tax is only imposed on purchases from out-of-state vendors that do not have sufficient nexus with Arizona to subject those out-of-state vendors to the imposition of Arizona's sales tax. As an additional factor, weighing on the side of nexus, Dunbar made arrangements to use the law firm as a display area for Dunbar's furniture, in order to show its product to other potential Arizona purchases. The Court of Appeals struck down the use tax assessment against O'Connor, Cavanagh, on the basis that Dunbar Furniture had sufficient nexus with Arizona through its installation activities, the presence of personnel in Arizona, and the display arrangement. The Department of Revenue filed a petition for review with the Arizona Supreme Court, which was denied.

City Use Tax on Car Purchased from Out-of-State Dealer. Clarence D. and Mary Ann Lamon v. Arizona Dep't of Revenue, Docket No. 1716-97-U (Bd. Of Tax Appeals) May 19, 1998. The Lamons protested the assessment of a Kingman City use tax on a vehicle that they ordered from a Georgia dealership (and on which they did *not* pay an equivalent Georgia excise tax). The car was shipped to them in Kingman. The Board found that the Lamons had not borne the burden of proving that the first actual use of the car was outside the City. KCC § 8A-660. Documents submitted to the Board by the Lamons showed that Chrysler Corporation was responsible for shipping the vehicle and that the Lamons picked it up at a Kingman dealership.