

**TAXATION OF CLEAN ROOMS:
SPECIAL TREATMENT FOR PROPERTY TAX & SALES AND
USE TAX**

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I. INTRODUCTION.

The Arizona Legislature has provided substantial tax benefits for clean rooms and their equipment. For property tax purposes, clean rooms will be treated as personal property and thus will be eligible for accelerated depreciation, and will not be taxed while under construction.

On the sales and use tax side, there is an exemption for the sale of clean room machinery and equipment. Additionally, the installation, assembly, maintenance and repair of clean rooms will not be subject to tax under the prime contracting classification.

II. PROPERTY TAX BENEFITS FOR CLEAN ROOMS.

A. Clean Rooms are Classified as Personal Property.

As background, although the Department of Revenue in its Personal Property Manual, characterized clean rooms as personal property (*see* Chapter 2, Table 2.1 at 2.20), the Maricopa County Assessor had taken the position that clean rooms should be considered a part of the building and valued as real property. As personal property, the clean rooms would be entitled to accelerated depreciation and would not be taxed during construction. On the other hand, if they were treated as a part of the structure and valued as real property, their useful life would be much

longer and they would not be eligible for accelerated depreciation or not being taxed while under construction.

In response to Maricopa County's position, Laws 1997, ch. 61 (S.B. 1050) codifies the historical administrative practice of valuing and assessing clean rooms as personal property and states the intent of the legislature that this historical practice should be continued. This legislation established a new A.R.S. § 42-235.04 (now § 42-15066) which provides as follows:

A. Clean rooms that are used for manufacturing, processing, fabrication or research and development of semi-conductor products shall be valued and assessed as tangible personal property.

B. . . . "[C]lean room" means all property that comprises or creates an environment where humidity, temperature, particulate matter and contamination are precisely controlled within specified parameters, without regard to whether the property is actually contained within that environment or whether any of the property is affixed to or incorporated into real property. Clean room:

1. Includes the integrated systems, fixtures, piping, moveable partitions, lighting and all property that is necessary or adapted to reduce contamination or to control air flow, temperature, humidity, chemical purity or other environmental conditions or manufacturing tolerances, as well as the production machinery and equipment operating in conjunction with the clean room environment.

2. Does not include the building or a permanent, non-removable component of the building that houses the clean room environment.

A.R.S. § 42-15066.

B. *Valuation of Clean Rooms: Tax Break During Construction, Favorable Depreciation, and \$50,000 Exemption Per Facility.*

1. *Personal Property Construction Work in Progress is Exempt From Taxation.*

Both secured and unsecured personal property construction work in progress is exempt from taxation until the construction work has progressed to a significant degree for the personal property to be used. Once the property is placed in service and is being used, it will generate income, at which time it will be subject to

tax. Prior to the time that it generates income, there will be no tax. See A.R.S. § 42-15065(A). “Personal property construction work in progress” is defined as “the amount spent and entered on the taxpayer’s accounting records as of December 31 of the preceding calendar year as construction work in progress.” § 42-15065(B).

2. *Clean Rooms are Entitled to Accelerated Depreciation.*

Clean rooms qualify as class 1.10 property used in manufacturing. A.R.S. § 42-12001(10). An accelerated depreciation schedule is available for personal property initially classified after tax year 1993 as class 1.8, 1.9, 1.10, or 1.13 property (property used in shopping centers, golf courses, manufacturing and any commercial or industrial use not otherwise listed in property class one). A.R.S. § 42-13054(B). To encourage capital investment in Arizona, the legislature has adopted a four-year accelerated depreciation schedule for these classes of personal property. The 1998 legislature increased those accelerated depreciation factors, beginning in the 1999 tax (calendar) year. The accelerated depreciation factors are as follows:

TAX YEAR	ACCELERATED DEPRECIATION FACTOR	INCREASED FACTOR (EFFECTIVE 1/1/1999)
1	40% of scheduled depreciated value	35%
2	50% of scheduled depreciated value	51%
3	72% of scheduled depreciated value	67%
4	88% of scheduled depreciated value	83%
5	For the fifth and following years, the assessor is to use the scheduled depreciated value as prescribed in the Department's Guidelines	

A.R.S. § 42-13054. These accelerated depreciation factors do not apply to centrally valued property (property valued by the Department). § 42-13054(C)(1).

3. *Residual Value: Going, Going (Almost Gone).*

“Residual value” is the minimum value allowable for property tax purposes, and is prescribed by the Department. The legislature required the Department to reduce the residual value of personal property including class 1.10 personal property by 2.5 percentage points per year for tax years 1996 through 1999, from 20 percent to a 10 percent floor for tax year 1999. Beginning in 2000, the minimum value was reduced again by 2.5% per year for three years to a new floor of 2.5% in 2002. See A.R.S. § 42-13055.

4. *Exemption For Personal Property – First \$50,000.*

Although clean rooms rarely cost less than \$50,000, the first \$50,000 of value of personal property is exempt from tax. As background, in the November 1996 general election, the voters approved an amendment to the Arizona Constitution which exempts the first \$50,000 by value of personal property from

taxation. This exemption is applicable beginning from and after December 31, 1996 (in other words, it first applied to the 1997 calendar year). The exemption applies only to certain classes agricultural personal property and several subclasses of class one personal property including class 1.10, which covers clean rooms. A.R.S. § 42-11127(A)

The Department of Revenue must increase the maximum amount of the exemption on an annual basis to take into account inflation. Specifically, on or before December 31 of each year, the Department is to increase the maximum amount of the exemption for the following tax year based on the average annual percentage increase, if any, in the GDP price deflator in the two most recent complete state fiscal years. "GDP price deflator" means the average of the four implicit price deflators for the gross domestic product reported by the United States Department of Commerce or its successor for the four quarters of the state fiscal year. *See* A.R.S. § 42-11127). For 2005, the Department increased the exemption to \$57,632. For 2006, the exemption amount is \$59,099. *See* Ariz. Dep't of Revenue, Prop. Tax Div., *Personal Property Manual* 4.13.

Note: In 1998 the legislature expanded the exemption to apply to \$50,000 of full cash value at each business location. The Court of Appeals invalidated the expanded exemption by ruling that the constitutional amendment permitting the exemption limited it to \$50,000 per single taxpayer. *Maricopa County v. Kinko's Inc.*, 203 Ariz. 496, 498-500, 56 P.3d 70, 72-74 (Ct. App. 2002); *Circle K Stores, Inc. v. Apache County*, 199 Ariz. 402, 404, 18 P.3d 713, 715 (Ct. App. 2001).

III. SALES AND USE TAX TREATMENT OF CLEAN ROOMS.

Both the sale of clean room equipment is exempt from the sales tax under the retail classification (as well as the use tax) and its installation and assembly is exempt from the sales tax under the prime contracting classification.

A. *Exemption for Sale of Clean Room Equipment.*

Clean rooms that are used for manufacturing, processing, fabrication or research and development of semiconductor products are exempt from the sales tax under the retail classification. *See* A.R.S. § 42-5061(B)(17). Clean rooms are also exempt from the use tax. A.R.S. § 42-5159(B)(17)).

Clean rooms are defined to "mean all property that comprises or creates an environment where humidity, temperature, particulate matter and contamination are precisely controlled within specified parameters, without regard to whether the property is actually contained within that environment or whether any of the property is affixed to or incorporated into real property." The statutory exemption goes on to clarify that a clean room:

(a) includes the integrated systems, fixtures, piping, moveable partitions, lighting and all property that is necessary or adapted to reduce contamination or to control air flow, temperature, humidity, chemical purity or other environmental conditions or manufacturing tolerances, as well as the production machinery and equipment operating in conjunction with the clean room environment.

(b) does not include the building or permanent, non-removable component of the building that houses the clean room environment.

§ 42-5061(B)(17). In short, the clean room exemption applies to all of the necessary machinery and equipment used in a clean room environment except for the building that houses the clean room environment.

B. Exemption for Installation of Clean Room Equipment.

Not only is clean room machinery and equipment exempt from the sales and use tax, but its installation, assembly or repair is exempt from the sales tax under the prime contracting classification. Specifically, the gross receipts of a contractor from the installation, assembly, repair or maintenance of clean rooms is deductible from the prime contracting classification, where the clean rooms in question qualify for the sales tax exemption under A.R.S. § 42-5061(B)(17) (*see* Part III.A, above). A.R.S. § 42-5075(B)(12). Thus, if the clean room equipment qualifies for exemption from the sales tax under the retail classification, then its “installation, assembly, repair or maintenance” will not be taxable under the prime contracting classification. *See* A.R.S. § 42-5075(B)(12).

The prime contracting deduction for gross income from the installation, assembly, or repair of clean room machinery and equipment is separate and distinct from the prime contracting deduction for gross income from the installation, assembly, or repair of machinery, equipment, or other tangible personal property that is deducted from the tax base of the retail sales classification under Section 42-5061(B) or exempt from use tax under A.R.S. § 42-5159(B) (the “general” deduction). § 42-5075(B)(7), (12). The general deduction contains different tests and exclusions than the prime contracting “clean room” deduction does. First, the general machinery and equipment deduction excludes property that is “permanently attached” to real property and provides three different definitions for “permanent attachment.” Only one definition need apply in order to exclude the property installed, assembled, or repaired from the deduction. The general deduction also disregards, for purposes of permanent attachment, separate ownership of the real property and the personal property installed, assembled, or repaired. Moreover, the general deduction does not apply to any gross income from activity that prepares the real property for the installation or assembly of

the personal property. § 42-5075(B)(7). In contrast, the deduction for installation, assembly, or repair of clean room machinery or equipment only requires that the equipment or machinery satisfy the retail sales classification's definition of a "clean room," which, insofar as any distinction between real and personal property applies, only excludes "the building" and any "other permanent, nonremoveable component of the building that houses the clean room environment." §§ 42-5075(B)(12), 42-5061(B)(17). Thus, while the general deduction excludes anything permanently attached to real property, the clean room deduction only excludes the building and building components that i) are permanent *and* nonremovable, *and* ii) house the clean room environment.

Retroactive Effective Date. This deduction for the installation of clean room equipment is retroactive to December 31, 1989.

C. *No Need for Purchase Agency Agreement.*

Additionally, a contractor that contracts with a manufacturer for the furnishing and installation of clean room equipment does not need to enter into a purchase agency agreement with the owner to act as the owner's agent in purchasing the exempt clean room equipment in order to deduct the cost of the clean room equipment from its contracting gross receipts. The elimination of the purchase agency requirement is effective January 1, 1999. Previously, for a contractor to be able to deduct the cost of otherwise exempt machinery and equipment that it was furnishing and installing from the prime contracting tax base, that contractor had to enter into a purchase agency agreement with the owner to act as the owner's agent in purchasing the exempt machinery and equipment. The reason being that the machinery and equipment was under the retail classification of the sales tax statutes and not under the prime contracting classification. This legislation eliminates the need for contractors to enter into a purchase agency agreement with the property owner when selling and installing otherwise exempt machinery and equipment. Additionally, prime contractors are no longer required to enter into a purchase agency agreement for the building materials when performing work for qualifying hospitals and health care centers. The legislation eliminates the purchase agency requirement by listing the machinery and equipment deductions under the prime contracting classification in addition to the retail classification. *See* A.R.S. § 42-5075(B)(9); Laws 1998, ch. 90 (S.B. 1323).

Note: This legislation eliminates the need for a purchase agency agreement at the state level and not at the city level. The Model City Tax Code was also recently amended to eliminate the need for a purchase agency agreement effective retroactively to January 1, 1999.