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ARIZONA TAX: THE UTILITIES CLASSIFICATION OF THE ARIZONA TRANSACTION PRIVILEGE (SALES) TAX

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1. THE UTILITIES CLASSIFICATION – A.R.S. § 42-5063.

The utilities classification is comprised of the business of:

a. Producing and furnishing or furnishing to consumers natural or artificial gas and water. *See* A.R.S. § 42-5063.A.1.

b. Providing to retail electric customers ancillary services, electric distribution services, electric generation services, electric transmission services and other services related to providing electricity is taxable under the utilities classification. A.R.S. § 42-5063.A.2. This provision was put into place to cover the taxation of such services after deregulation of the electric utility industry in Arizona. Ancillary services include the services necessary to support the transmission of electricity from resources to loads while maintaining reliable operation of the transmission system according to good utility practice. A.R.S. § 42-5063.D.1.

2. CASES

In *Tucson Elec. Power C. v. Arizona Dep't of Revenue,* 170 Ariz. 145, 822 P.2d 498 (App. 1991), the Court broadly interpreted what constituted the business of producing and furnishing electricity and held that Tucson Electric Power Co. was liable for tax on payments that did not result from actually furnishing electricity. In 1979, Tucson Electric entered into an electric service agreement with Cyprus Pima Mining Company (Pima) under which Tucson Electric agreed to supply electricity up to a certain maximum amount for the operation of the Pima Mine. The parties also agreed that Pima would pay Tucson Electric for specified minimum amounts of electricity each month even if its actual use was less. In 1982, the mine was shut down and electrical usage dropped far below the minimum demand. This situation continued for the years 1983 through 1985, the ending date of the service agreement. During the term of the agreement, Tucson Electric collected a percentage of the total charges from Pima as transaction privilege taxes and remitted those amounts to the Department.

On November 3, 1986, Tucson Electric filed with the Department a claim for refund of approximately $250,000 in transaction privilege taxes paid from July 0f 1983 through July of 1985 on Pima's minimum demand charge payments. The Department denied the refund claim and Tucson Electric protested the denial to the Department's appeals process. The Department's hearing officer held that Tucson Electric was not liable for tax in excess of the cost of electricity actually furnished. The hearing officer's decision, though, was overruled by the Director of the Department, which was upheld by the Arizona board of Tax Appeals and by the Arizona Tax Court.

On appeal, Tucson Electric reiterated the position taken by the Department's hearing officer and contended that it was liable for sales tax only on amounts received from Pima which were for electricity actually furnished. It argued that, to the extent its minimum demand charge receipts do not represent actual sales of electricity, they constituted income from "incidental or extraneous activities" that were not subject to tax. It contended that only the furnishing or sale of electricity was subject to tax, and that income from other extraneous matters is outside the scope of the statute and not taxable. State sales taxes are measured by gross income from specific activities. In the case of Tucson Electric, the tax was one percent of its gross income from the business of producing and furnishing, or furnishing, to consumers, electricity, electric lights, current, power or gas, natural or artificial, and water.

The Court compared these provisions with the comparable taxing provisions for selling tangible personal property at retail. It noted that the definition of business included all activities or acts, engaged in or caused to be engaged in with the object of gain, benefit or advantage, either directly or indirectly. It also noted that gross income meant the gross receipts of a taxpayer derived from trade business, commerce or sales and the value proceeding or accruing from the sale of tangible personal property, or service or both. Because gross income not only includes gross receipts from sales but also the value from the sale of tangible personal property or service or both, the Court concluded that if the business of producing and furnishing electricity includes a service component for which the taxpayer is compensated, then those amounts are fully taxable under this business classification. The Court concluded that the business of producing and furnishing electricity not only includes the actual selling of electricity as a commodity but also providing the numerous continuing service necessary to deliver the electricity to the customer reliably and in a useful form.

This was consistent with the agreement between Pima and Tucson Electric. Tucson Electric had agreed not only to supply total electric power, but also to (1) operate and maintain the facilities required to furnish service to the points of delivery; (2) to provide service consistent with modern engineering practices in the operation of its generating equipment; (3) to permit the use of certain control circuits on Pima's property; (4) to furnish, install, maintain and calibrate suitable metering equipment; and (5) to read the meters monthly and render monthly statements of account. In the Court's opinion, these services were just as much a part of Tucson Electric's business of producing and furnishing electricity as its actual sales of electricity.

The Court also rejected Tucson Electric's contention that the taxation of the minimum demand charges should be taxed prospectively only since such receipts have never been taxed before. The Court rejected this contention, holding that because Tucson Electric had not relied on any court decision that the minimum demand charge revenue was not taxable, it cannot claim to be injured by retroactive taxation.

In *Winterhaven Water & Dev. Co. v. Arizona Dep't of Revenue,* Arizona Board of Tax Appeals, Division 2, No. 638-88-5 (July 17, 1989), the Board held that a cooperative water company incorporated as a non-profit corporation for the mutual benefit of owners and residents of property in a subdivision is liable for the sales tax on the monthly charges paid by the members to whom it furnishes water. The water company was not exempt because it was a cooperative venture of its members.

In *Arizona Public Serv. Co. v. Arizona Dep't of Revenue,* Arizona Board of Tax Appeals No. 692-89-S (October 3, 1990), the taxpayer contended that income from phone drops, a service provided to telephone or cable television companies, was exempt from taxation under the utility classification or, alternatively, taxable as contracting. A phone drop is the connecting of telephone or cable wiring to APS wiring and placing them into trenches dug by APS for its

own underground electrical wiring. The Board concluded that the providing of phone drops was taxable as contracting and entitled to the 35% in lieu of labor deduction. The installation of armored electrical cables, conversion of overhead electrical lines to underground lines, relocation of electrical lines to accommodate changes in real property and installation and removal of temporary electrical facilities at construction sites were held to be exempt from taxation as equipment installed to provide utility access to utility customers which becomes property of the utility.

3. SECURITY DEPOSITS.

Security deposits are not subject to the sales tax until recognized by the utility as "earned income." R15-5-2210.

4. IRRIGATION DISTRICTS.

Electricity or gas furnished to an irrigation district for the purpose of producing water for irrigation of farm lands is subject to the sales tax. R15-5-2107; *see also Arizona Public Serv. Co. v. Department of Revenue*, Arizona Board of Tax Appeals, No. 306-83-S (April 10, 1095). In *Flowing Wells Irrigation Dist. v. City of Tucson*, 176 Ariz. 623, 863 P.2d 915 (Tax Ct. 1993), the Arizona Tax Court held that the City of Tucson may assess its sales tax on an irrigation district's income from the sale of water to residential customers because supplying water to such customers is a proprietary function, which is taxable, and not an exempt governmental function.

5. DEDUCTIONS AND EXEMPTIONS.

The following exclusions and deductions are allowed under the utilities classification:

Exclusions:

a. Sales of ancillary services, electric distribution services, electric generation services, electric transmission services and other services related to providing electricity, gas or water to a person who resells the services.

b. Sales of natural gas or liquefied petroleum gas used to propel a motor vehicle.

c. Sales of alternative fuel, as defined in § 1-215, to a used oil fuel burner who has received a permit to burn used oil or used oil fuel under § 49-426 or 49-480.

d. Sales of ancillary services, electric distribution services, electric generation services, electric transmission services and other services that are related to providing electricity to a retail electric customer who is located outside this state for use outside this state if the electricity is delivered to a point of sale outside this state.

Deductions

a. Revenues received by a municipally owned utility in the form of fees charged to persons constructing residential, commercial or industrial developments or connecting residential, commercial or industrial developments to a municipal utility

system or systems if the fees are segregated and used only for capital expansion, system enlargement or debt service of the utility system or systems.

b. Revenues received by a person or persons owning a utility system in the form of reimbursement or contribution compensation for property and equipment installed to provide utility access to, on or across the land of an actual utility consumer if the property and equipment become the property of the utility. This deduction shall not exceed the value of such property and equipment.

c. Gross proceeds of sales or gross income derived from sales to:

   i. Qualifying hospitals as defined in § 42-5001.

   ii. A qualifying health care organization as defined in § 42-5001 if the tangible personal property is used by the organization solely to provide heal and medical related educational and charitable services.

d. The portion of gross proceeds of sales or gross income that is derived from sales to an environmental technology manufacturer, producer or processor as defined in § 41-1514.02 of a utility product and that is used directly in environmental technology manufacturing, producing or processing,. This exemption applies for fifteen full consecutive calendar of fiscal years from the date the first paper manufacturing machine is placed in service. In the case of an environmental technology manufacturer, producer or processor who does not manufacture paper, the time period shall begin with the date the first manufacturing, processing or production equipment is placed in service.

6. USE TAX ON ELECTRICITY OR NATURAL GAS PURCHASED FROM OUT-OF-STATE PROVIDER.

The use tax is imposed on the consumer of electricity or natural gas which has been purchased from out-of-state seller of those items who has no nexus with Arizona. *See* A.R.S. § 42-5051 and § 42-5155. Without such a use tax on the in-state consumer, the out-of-state utility which has no nexus with Arizona would arguably not be subject to the transaction privilege tax so that the interstate sale would go completely untaxed. The Arizona Legislature enacted legislation in the 2000 Session which will conform city and county tax provisions relating to the sale of electricity and natural gas by out-of-state sellers with the state structure so that a county and city use tax will be imposed on the consumer, in addition to the state use tax.

7. PRIVATE TAXPAYER RULINGS

TPR01-2.

a. The sale of bottled water for home consumption by a qualified vendor is exempt from tax under the retail classification.

b. The business of producing and furnishing or furnishing water to consumers is subject to tax under the utilities classification. Cooperatives and municipalities

are in the business of producing and furnishing or furnishing water to consumers. If water haulers or other private entities own the water they deliver or provide, they, too, are in the business of producing and furnishing or furnishing water to consumers and are taxable under the utilities classification.

c. If a consumer purchases water from a third party and contracts separately with the water hauler to haul that water to the consumer, the water hauler is engaged in a transporting business activity. The transportation classification provides an exclusion from tax under the transportation classification if the motor carrier fee or the light motor vehicle fee is paid on the transporting vehicle.

d. The sale or delivery of water by the United States government, any state governmental entity, such as an agricultural improvement district or irrigation district, or an authorized agent thereof, that is acting in fulfillment of a governmental function is not subject to taxation.

LR 02-006. The department rules that the transaction privilege tax does not apply under either the retail classification or the utility classification, when taxpayer withdraws natural gas from out-of-state wells owned by taxpayer or in which taxpayer owns a working and/or possessory interest, whether by fee, mineral deed, lease, assignment of lease, or other real property interest.

LR 01-004. The department rules that the transaction privilege tax does not apply under either the retail classification or the utility classification, when taxpayer withdraws natural gas from out-of-state wells in which it has a working interest and has it transported by a pipeline company to Arizona. The department further rules that the use tax does not apply to natural gas that is consumed by taxpayer in its electric generating plant when such gas was withdrawn from out-of-state wells in which it has a working interest.

LR 95-014. The department rules that taxpayer will be subject to transaction privilege tax on sales of electricity delivered to the U.S. side of the border for use by end consumers in Mexico.

TPR 01-2: Deals with Water:

a. The department rules that the sale of bottled water for home consumption is exempt under the retail classification.

b. The department rules that the sale of water to consumers by either a co-op or municipality is taxable under the utilities classification.

c. The department rules that the transportation of water by truck (if not owned by the trucking company) is taxable under the transporting classification.

d. The department rules that the sale of water by U.S., state, agricultural improvement or irrigation district acting as a governmental function is not taxable.

