

**ARIZONA TAX: UPDATE ON THE 4" WATER
PIPE SALES TAX DEDUCTION**

By: Pat Derdenger, Partner
Steptoe & Johnson LLP
201 East Washington Street, 16th Floor
Phoenix, Arizona 85004-2382

**I. RETAIL SALES TAX EXEMPTION FOR WATER PIPES & VALVES FOUR
INCHES IN DIAMETER AND LARGER**

A.R.S. § 42-5061

- a. The retail classification is comprised of the business of selling tangible personal property at retail. The tax base for the retail classification is the gross proceeds of sales or gross income derived from the business. The tax imposed on the retail classification does not apply to the gross proceeds of sales or gross income from:
- b. In addition to the deductions from the tax base prescribed by subsection A of this section, the gross proceeds of sales or gross income derived from sales of the following categories of tangible personal property shall be deducted from the tax base:
- c. Pipes or valves four inches in diameter or larger used to transport oil, natural gas, artificial gas, water or coal slurry, including compressor units, regulators, machinery and equipment, fittings, seals and any other part that is used in operating the pipes or valves.

A.R.S. § 42-5159(B)(6) provides the same deduction for purposes of the Arizona use tax.

II. DEPARTMENT'S RULING ON 4" PIPE, TPR 02-2 –TYPES OF PIPE (USAGE)

Deduction is Based on the Purpose For Which the Pipe is Used

In TPR 02-2, the Department addressed the types of pipe that are covered by the 4" or larger pipe deduction under A.R.S. § 42-5061(B)(6). Specifically, the Department addressed whether "gross income from the sale of pipe 4" or larger in diameter used to transport sewage qualifies for the deductions from the tax base under the retail classification and the use tax.

The Ruling states that "[i]n analyzing the Statutes, one must look at the specific purpose for which the four-inch pipe ('pipe') is being used. It is both the purpose for which the pipe is used and the substance being transported through the pipe that is at the heart of the deduction allowed by the Statutes."

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The Ruling states, as an example, that “pipe used to transport water from a municipal water source to a factory qualifies for the deduction” because the “purpose of the pipe is to transport water.” The ruling differentiates this from the example of “pipe used to transport sewage from a factory to a municipal sewage treatment plant,” noting that the purpose of the pipe in that instance is to transport sewage, and that “[a]ny water used in the transportation of the sewage is a medium of transportation; the pipe is not used for the purpose of transporting water.” Thus, “income from the sale of pipe used for the purpose of transporting sewage is not deductible because the Statutes do not provide a deduction for the transportation of sewage.”

Definition of the Term “Water”

The Ruling notes that the term “water” is not defined by statute, and says that “[u]nless the Legislature clearly expresses an intent to give a term a special meaning, Arizona courts will give the words used in statutes their plain and ordinary meaning.” “In determining the ordinary meaning of a term, Arizona courts will refer to an established and widely used dictionary.”

The Ruling points to the dictionary definition of “water” as “an odorless, tasteless, very slightly compressible liquid oxide of hydrogen H₂O which appears bluish in thick layers, freezes at 0° C and boils at 100° C.” TPR 02-2 (citing *Webster’s Third New International Dictionary* 2581 (3d ed. 1993).) The Ruling also notes that “sewage” is defined by *Webster’s Dictionary* as “refuse liquids or waste matter carried off by sewers,” and concludes that it is “clear from the above definitions that sewage cannot be considered water under the plain definition of the term ‘water’.” The Department’s ruling in TPR 02-2 is that “Pipes or valves four inches in diameter or larger used to transport sewage will not qualify for a deduction under the Statutes.”

Examples of 4” or Larger Pipe and the Tax Treatment of Each

TPR 02-2 contains the following non-exhaustive list of examples of 4” or larger pipe and the taxability of the gross proceeds from sales or purchases of the pipe under A.R.S. §§ 42-5061(B)(6) or 42-5159(B)(6):

<u>Pipe Use</u>	<u>Taxability</u>
Storm water drainage system flowing to retention basins, waterbeds or washes	Not Taxable
Irrigation system	Not Taxable
Transporting from water reclamation/treatment facility to irrigation system	Not Taxable
Transporting from water reclamation/treatment facility to retention location, recharging facility	Not Taxable

Potable water distribution system for residential and business customers	Not Taxable
Sewage, waste or sanitary collection systems for residences, businesses or commercial enterprises	Taxable

III. AUDIT ISSUES RELATING TO THE 4” OR LARGER WATER PIPE DEDUCTION

In recent audits, the Department has questioned the documentation used by some contractors to support the amount of the deduction or refund claim, as well as the practice of taking a deduction in later months for previously installed water pipes, rather than filing an amended return or refund claim for the months in which the sales were actually made.

Determining the Amount of the Deduction or Refund Claim

In auditing some general contractors, the Department has taken the position that the amount of the deduction is limited to the subcontractors’ purchase price of the exempt 4” or larger pipes and valves. However, in some situations, it is not always possible for a general contractor to determine what was the subcontractor’s purchase price for the exempt items.

In an effort to simplify the process of claiming the 4” or larger water pipe deduction, and particularly in situations where subcontractors have been unwilling or unable to provide invoices of exempt purchases or otherwise document the actual cost of the exempt items, some general contractors have attempted to arrive at an appropriate deduction amount by extracting the cost of the exempt pipes and valves from the subcontractors’ pay applications. Various methods have been employed by taxpayers to determine the most appropriate percentage to use in calculating the deduction or refund claim under this alternative approach.

Some contractors have based their deduction amount of a study conducted several years ago to support a changeover in the contracting tax structure from taxing the prime contracting to taxing only the sale of building materials to all contractors, which is the method used by most all states. That study concluded that in an average commercial project, some 49% of the cost was for building materials. Contractors used that percentage to determine the amount of their pipe deduction or refund claim—taking 49% of the pipe contractor’s subcontract amount (which was a lump sum and not broken down between materials and installation). We understand that the Department previously accepted this approach at the audit level but has rejected it in a current audit. The Department’s position in the current audit is that the taxpayer must provide copies of the subcontractor’s invoices for the purchase of the exempt pipe.

Other contractors have reported that, in the past, auditors of the Department of Revenue have allowed them to apply a 65% - 35% breakout of materials (pipes & valves) versus labor to all pay applications relating to 4” or larger water pipes. This approach is based on the standard

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35% labor deduction (65% tax base) under the contracting classification under A.R.S. § 42-5075. Given the Department's current audit position in rejecting the 49% study approach (see above), we doubt that the Department would accept the 65% approach for the cost of the pipe.

Currently, there is no clear formal guidance on how to determine the proper amount of the 4" or larger water pipe deduction. In our opinion, any discussion of this issue should be guided by the statute:

A.R.S. § 42-5061

- a. In addition to the deductions from the tax base prescribed by subsection A of this section, the gross proceeds of sales or gross income derived from sales of the following categories of tangible personal property shall be deducted from the tax base:
- b. Pipes or valves four inches in diameter or larger used to transport oil, natural gas, artificial gas, water or coal slurry, including compressor units, regulators, machinery and equipment, fittings, seals and any other part that is used in operating the pipes or valves.

Under the statute, it is the taxable prime contractor that is entitled to a deduction *from the prime contractor's* gross receipts for the *prime contractor's* "gross income derived from sales of ... [p]ipes or valves four inches in diameter or larger used to transport oil, natural gas, artificial gas, water or coal slurry...." Based on the plain language of the statute, we don't see why a taxable prime contractor should not be allowed to break out and separately price the *prime contractor's* cost of providing the 4" or larger water pipes in its pay applications to the owner, thereby avoiding the problem of having to document the subcontractor's original purchase price of the exempt pipes and valves.

We note that this approach has not been formally approved by the Department, nor has this issue been resolved by the Arizona courts, and it is possible that the Department would take issue with this approach in an audit, though we believe this is the most consistent reading of the statute. For a contractor that encounters the 4" or larger water pipe deduction on a regular basis, this may well be a suitable issue for a managed audit.

Timing Issues – Take Current Deduction for Past Periods or File Amended Returns or Claim for Refund?

The second issue relating to the 4" or larger water pipe deduction that the Department has raised on audit has to do with timing issues. Rather than filing amended returns or refund claims for prior periods in which a contractor could have taken a deduction but did not, some contractors have instead taken the past deductions and applied them to current returns, in some cases spreading the deductions out over multiple returns. The risk with taking this approach is that the Department, on audit, may well disallow the deductions for the current periods, and if the statute of limitations has lapsed for the periods in which the deductions could have been taken, the taxpayer may be placed in a difficult situation: having the current deduction

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disallowed without the ability to file an amended return or refund claim for the prior periods. We do not recommend this approach. We recommend that amended returns or a claim for refund be filed for prior periods. The statute of limitations for filing a refund claim is the same period in which the Department may issue an assessment (generally, four years):

A.R.S. § 42-1106. Time limitations for credit and refund claims

- a. The period within which a claim for credit or refund may be filed, or credit or refund may be allowed or made if no claim is filed, is the period within which the department may make an assessment under § 42-1104.
- b. The failure to begin an action for refund or credit within the time specified in this section is a bar against the recovery of taxes by the taxpayer.

A.R.S. § 42-1104. Statutes of limitation; exceptions

- a. For the taxes to which this article applies every notice of every additional tax due shall be prepared on forms prescribed by the department and mailed within four years after the report or return is required to be filed or within four years after the report or return is filed, whichever period expires later.