



A Dash of SALT

How Arizona Sales Tax Reform Will Affect Contractors

This month's state and local tax (SALT) column focuses on how Arizona's transaction privilege ("sales") tax reform efforts will affect construction contractors.

In 2013, Arizona Governor Jan Brewer successfully pushed for sales tax reform. Most of the changes, which will be effective on January 1, 2015, simplify the way businesses in Arizona report and pay their sales taxes and the way sales tax audits will be conducted and resolved. However, the changes also will substantively affect some construction contractors' sales tax obligations.

How Construction Contractors Currently Are Taxed in Arizona

In most states, contractors simply pay sales tax on building materials when they purchase them. However, in Arizona, contractors currently are entitled to purchase building materials tax free because they are subject to a separate, "prime contracting," sales tax on 65% of their gross receipts from supervising, performing, or coordinating construction or demolition activities instead. So, for example, an Arizona contractor who is paid \$1,000,000 to construct a building is able to purchase the building materials used to construct the building tax free but is subject to Arizona sales tax on 65% of its gross receipts, or \$650,000. Under these existing rules, a plumbing company or another trade contractor that performs hundreds of small jobs all over the state in a particular month would have to keep track of where each job was performed, file a sales tax return to the state and,

perhaps, multiple sales tax returns to different municipalities to account for its monthly sales tax obligations.

Governor Brewer's Proposal

During the 2013 legislative session, Governor Brewer encouraged Arizona's legislature to repeal Arizona's separate prime contracting sales tax and just have contractors pay sales tax on the building materials they purchase instead, like contractors do in most other states. However, Arizona municipalities successfully lobbied against this proposal because they were concerned about the fiscal impact of this change (prime contracting taxes are paid to the city where the construction is performed, while retail sales taxes are paid to the city where the retailer is located).

The Compromise

Accordingly, Gov. Brewer and Arizona's legislature agreed to a compromise with the cities under which: (1) new construction will continue to be taxed under Arizona's existing rules (i.e., no tax on building materials when the contractor purchases them because the contractor is subject to Arizona's separate prime contracting tax on 65% of their gross receipts instead), but (2) contractors who enter into a contract with an owner of real property only to maintain, repair, replace, or alter that property are subject to tax on building



materials when they purchase them, but they are not subject to Arizona's separate prime contracting tax.

The Taxation of Contractors in Arizona, as of Jan. 1, 2015

Under the terms of this compromise, it will be business as usual for contractors who only engage in new construction activities (i.e., they will be subject to Arizona's prime contracting sales tax on 65% of their gross proceeds from new construction projects). And, contractors who only enter into contracts with owners of real property to maintain, repair, replace, or alter their property will only be subject to sales tax under the new rules (i.e., they will pay tax on building materials when they purchase them, but they are not subject to Arizona's separate prime contracting tax). The compromise should make it easier for trade contractors who perform hundreds of small jobs all over the state in a given month to comply with their sales tax obligations.

However, contractors who both engage in projects involving new construction and enter into contracts with owners of real property to maintain, repair, replace, or alter their existing property will have to comply with both

Arizona's old sales tax rules for projects involving new construction and with Arizona's new sales tax rules for projects involving contracts with owners of real property to maintain, repair, replace, or alter their existing property.

Some issues to grapple with for contractors subject to tax under both the old and the new rules:

How to separately account for and pay tax on building materials used on projects that fall under the new rules, but not on projects that fall under the old rules; and

Distinguishing between projects that fall under the old rules versus the new rules (e.g., what is the dividing line between maintaining, repairing, replacing, or altering existing property versus new construction? And, the new rules may not apply to construction contracts with lessees versus owners).

Practice Tip! – CPAs who work with or for contractors may want to familiar-

ize themselves with how Arizona sales tax reform will affect contractors by attending the ASCPA's Arizona Tax Luncheon on December 11, 2014. The ADOR employee responsible for implementing the new rules will make a presentation and answer our questions. **AZ CPA**

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