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ARIZONA TAX RESEARCH ASSOCIATION

ATRA SUPPORTS HB2749

Simplifies Residential Contracts under Prime Contracting

Arizona's prime contracting tax is generally regarded as the most complex and inefficient area of Arizona's transaction privilege tax (TPT) system. Unlike most other states that tax materials at retail, Arizona's prime contracting tax system allows contractors to purchase materials tax-free at retail with the use of exemption certificates, and instead, pay taxes on 65% of the gross proceeds of the contract upon completion of the project. The ability to purchase materials tax-free on an honor system can certainly lead to noncompliance- not an ideal feature of any tax system.

In 2012, Governor Brewer's TPT Simplification Task Force recommended the state "aggressively" transition from the current prime contracting tax to a tax on materials at retail. Although a total elimination of prime contracting was not accomplished, the Legislature did achieve carving out certain activities from the contracting tax to a tax on materials at retail that involved maintenance, repair, replacement, and alteration (within certain thresholds), now known as MRRA.

All maintenance, repair, and replacement activities were moved from prime contracting to retail. However, for "alteration" projects to qualify under MRRA and remain subject to the retail tax, certain thresholds could not be exceeded. For residential property, the contract price for the alteration cannot exceed 25% of the property's full cash value and \$750,000 for commercial property. For either a residential or commercial contract, there is a 25% cushion for changes made to contracts that may initially qualify under MRRA without being pulled back into prime contracting.

While the intent of MRRA was to simplify tax compliance for contractors, there is still much confusion as to which activities are considered an "alteration" to property (subject to the prime contracting tax if the 25% threshold is exceeded) or if the activity is considered "replacement" (subject to tax under MRRA). For example, according to guidance provided by the Arizona Department of Revenue (ADOR), a residential contract to remodel a kitchen that includes replacement of existing flooring and appliances is considered MRRA. However, if the contract also includes the addition of a new kitchen island, the entire contract is then considered an "alteration" and would be subject to the prime contracting tax if it breaches the 25% threshold.

HB2749 will simplify residential MRRA projects under the Prime Contracting class so that residential contracts that do not involve adding or expanding the square footage of the structure will pay tax on the materials at retail rather than be subject to the prime contracting tax.