ATRA SUPPORTS HB2807

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 has led to serious noncompliance concerns for many years.** **[A 2019 study commissioned by the Arizona Department of Revenue determined that the noncompliance under the prime contracting tax could be as high as 19% (*Prime Contracting Study, ASR Analytics*).]**

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.

Under MRRA, all materials included in a contract for maintenance, repair, and replacement activities are subject to tax at retail regardless of the contract amount. However, the contract cost for "alteration" activities must remain within specific thresholds for the materials to remain taxable at retail, otherwise the contract may be taxable under the prime contracting tax. For residential alteration projects, the contract price cannot exceed 25% of the property's full cash value.

While the intent of MRRA was to simplify tax compliance for contractors, the lines remain blurred for contractors that enter into contracts for jobs that involve alteration activities. **This area of taxation is so complicated that the guidance provided by the Department of Revenue (DOR) is over 20 pages long and includes over 30 scenarios *(TPN 18-1)*.** For example, according to this guidance, a residential contract to remodel a kitchen that includes adding a kitchen island (modification) could move an alteration project under MRRA into prime contracting if the total contract price exceeds 25% of the home value.

<u>Examples of Specific Scenarios</u>

1. *Scenario*: A homeowner decides to remodel her kitchen. The owner hires a contractor and has him replace all of the existing appliances and flooring. Additionally, the homeowner decides to have the contractor install a new island that did not previously exist. The full cash value of the home at the time of bid is $200,000. The contract price is $40,000.

Result: This contract is not subject to prime contracting TPT. The addition of the kitchen island causes this project to be treated as either an alteration project or a modification project. Because the contract price is only 20% of the of the full cash value of the property, the project meets the definition and criteria for an alteration and is therefore exempt from TPT. The materials to be used in this MRRA contract are subject to retail TPT.

HB2807 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.

ATRA ASKS LAWMAKERS TO VOTE YES ON HB2807!

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