



March 1, 2023  
Rep. Michael Carbone  
AZ House of Representatives  
District 25

Katie Hobbs  
Governor

Robert Woods  
Director

Dear Rep. Carbone:

This letter is written in response to your request to the Department for clarifying information related to contracting. More specifically, you inquired about certain statements made by Mr. Nick Ponder of the League of Cities and Towns during testimony for HB2807, as follows:

1. A kitchen remodel would be considered an "alteration" under MRRA because it is a change of one system, whereas a remodel of an entire home would be considered prime contracting since it entails the remodel of more than one system.

Short Response: This statement apparently introduces a new interpretation of alteration that is unsupported by the law. Below, the existing law is summarized with a couple of examples.

2. All of the revenues generated for materials incorporated into MRRA contracts go to the places where the materials are sold and not to the location of the project.

Short Response: This statement is simply inaccurate. The law requires TPT licensed contractors that purchase MRRA materials tax-exempt to report taxes on those materials based on the location of the project. In fact, according to data collected by the Department, cities have collected \$4,516,085.75 of tax on materials for MRRA projects for fiscal 2022, which has been paid to the cities where the construction activity took place. Assuming an average city tax rate of 2.3%, this means that approximately \$196m of taxable materials used in MRRA projects have been reported to the cities where the work is being performed.

## Discussion

In relation to the first statement, whether a kitchen remodel is considered an alteration under MRRA, depends on what that remodel entails. A kitchen remodel where the scope of work includes only the replacement of items in the kitchen would indeed be considered MRRA, but it would be *replacement* MRRA, not *alteration* MRRA; therefore, the *alteration* thresholds will not apply and, as a result, the cost of the project is irrelevant.

If, on the other hand, the remodel requires that the kitchen be laid out differently and/or the square footage of the kitchen changes, then it is likely that some components of the project would be *alteration* and others would be *replacement*. It all depends on what is required to

be done in each case. In addition, while the statute defines an *alteration* as any activity or action that causes a direct physical change to existing property, it also specifies that *alteration* does not include maintenance, repair or replacement. As you may recall, maintenance, repair and replacement do not have thresholds, whereas alteration does. As a result, it is very important that all the elements of the project be categorized correctly.

In relation to the second statement, a special emergency bill, Laws 2015, Chapter 4, Section 6 (SB 1446), was passed to overhaul and make workable the newly bifurcated method of taxing the construction industry. One key issue that was addressed in this bill of particular relevance here relates to contractors' inventory and materials procurement. In the prior approaches to the new bifurcated taxing scheme (2013 and 2014 legislation), all MRRA materials were to be purchased with tax paid (i.e., taxable sales), whereas all prime contracting materials were to be purchased tax-exempt. This reality created significant concern among many contractors. Here's why: contractors tend to purchase materials in bulk for quantity discounts and for the convenience of having certain regularly used materials on hand. The problem was that if some items of inventory were purchased with tax paid (for MRRA jobs) and some were purchased without tax (for traditional prime contracting jobs), inventory control would have become significantly more complicated and the risk of error much greater than previously had been the case.

Accordingly, these issues were addressed by specifically allowing contractors the choice of (1) paying tax on MRRA materials at the time of purchase, or (2) purchasing MRRA materials tax-exempt (consistent with their purchases of materials for prime contracting jobs) and then, when the tax-exempt materials are used in a MRRA project, the contractor would report and pay retail TPT *to the jurisdiction in which the project is located*. This is specifically provided by § 42-5008.01(A)(1) as follows:

The amount of liability shall be calculated **and reported based on the location of the [MRRA] project** and the taxes imposed under this chapter and chapter 6 of this title.

For proper reporting purposes, contractors are required to state the cost of MRRA materials and to calculate the retail equivalent TPT on those materials based on the location of the project. Tax returns for contractors indicate that, for fiscal 2022, cities where MRRA projects have taken place have collected \$4,516,085.75 of tax on MRRA materials. Assuming an average city tax rate of 2.3%, this means that approximately \$196m of taxable MRRA materials were reported to the cities where the work was performed.

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I hope this information is of assistance to you. If you have any further questions, feel free to contact the Department again.

Sincerely,

*Lisa Querard*

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Taxpayer Services Section  
Arizona Department of Revenue