ISSUE:

Tax consequences on the sale of machinery or equipment to be used in treatment of wastewater/sewage and water.

APPLICABLE STATUTORY AUTHORITY:

Transaction Privilege Tax

Arizona Revised Statutes ("A.R.S.") § 42-5061 Retail Classification, imposes the transaction privilege tax on the business of selling tangible personal property at retail. All sales of tangible personal property are subject to tax unless specifically exempted by statute.

A.R.S. § 42-5061(B)(1) states that machinery, or equipment, used directly in manufacturing, processing, fabricating, job printing, refining or metallurgical operations shall be deducted from the tax base.

Arizona Administrative Code ("A.A.C.") R15-5-120 defines the term “machinery or equipment” used in “processing” and “manufacturing”.

A.A.C. R15-5-120(A) states:

[m]achinery or equipment used in manufacturing or processing includes machinery or equipment that constitutes the entire primary manufacturing or processing operation from the initial stage where actual processing begins through the completion of the finished end product, processing, finishing, or packaging of articles of commerce. Manufacturing is the performance as a business of an integrated series of operations which place tangible personal property in a form, composition, or character different from that in which it was acquired and transforms it into a different product with a distinctive name, character, or use.

A.A.C. R15-5-120(B) states:

[g]ross receipts from the sale of repair or replacement parts for exempt machinery or equipment are not subject to the tax under the retail classification. Repair and replacement parts are defined as those individual component and constituent items that, together, comprise exempt machinery or equipment.
A.A.C. R15-5-181(A) provides that the gross receipts from sales of tangible personal property to the state or its political subdivisions are taxable unless otherwise exempt.

A.A.C. R15-5-181(B) provides that gross receipts from the sale of tangible personal property by the state or its political subdivisions, when acting in a proprietary capacity, are taxable unless otherwise exempt.

Use Tax

A.R.S. § 42-5155 imposes an excise tax on the storage, use or consumption in this state of tangible personal property purchased from a retailer or utility business.

A.R.S. § 42-5159(B)(1) states that machinery, or equipment used directly in manufacturing, processing, fabricating, job printing, refining, or metallurgical operations shall be exempt from tax.

A.A.C. 15-5-2320(A) states:

[machinery or equipment used in manufacturing or processing includes machinery or equipment that constitutes the entire primary manufacturing or processing operation from the initial stage where actual processing begins through the completion of the finished end product, and that is used in the production, manufacture, fabrication, processing, finishing, or packaging of articles of commerce. Manufacturing is the performance as a business of an integrated series of operations which place tangible personal property in a form, composition, or character different from that in which it was acquired, and transforms it into a different product with a distinctive name, character, or use.]

A.A.C. 15-5-2320(B) states:

[purchase of repair or replacement parts for exempt machinery or equipment is not subject to the use tax. Repair and replacement parts are defined as those individual component and constituent items which, together, comprise exempt machinery or equipment.]

Moore v. Farmers Mut. Mfg. & Ginning Co., 51 Ariz. 378, 77 P.2d 209 (1939) provides the following definition of “processing”:

to subject (especially raw material) to a process of manufacturing, development, preparation for market, etc.; to convert into a marketable form, as livestock by slaughtering, grain by milling, cotton by spinning, milk by pasteurizing, fruits and vegetables by sorting and repacking.
QUESTIONS AND ANSWERS:

Q: When does the sale or purchase of machinery or equipment qualify for a deduction, or exemption, from the gross income when used in wastewater/sewage and water treatment?

A: It is the specific use of the machinery or equipment in a given situation that will determine the tax consequences. A vendor may deduct the gross income when the equipment is used directly in the manufacturing or processing operation. On the other hand, machinery or equipment performing an ancillary function to facilitate the manufacturing or processing operation shall not be deducted from the tax base; nor shall machinery or equipment used to create byproducts. The same general rule applies under the use tax for machinery and equipment purchased from an out of state vendor.

In the past, wastewater/sewage treatment was considered separate from water treatment and there was no article of commerce produced. More recently, water treatment plants have been built as part of an integrated reclamation process which includes the wastewater/sewage treatment process as part of the reclamation process with the intent of producing end products that can be sold, creating an article of commerce. In this situation, the gross income from sales of machinery or equipment used directly in the wastewater/sewage and water treatment process is deducted from the tax base because there is a product produced and offered for sale once the process is complete. Similarly, when the purchases of machinery or equipment used directly in the wastewater/sewage and water treatment process is exempt from use tax if there is a product produced and offered for sale once the process is complete.

When the gross income from the sale or purchase of such machinery or equipment is deducted or exempt, as described above, then normally the sale of the end products will be taxable.

Q: Is a deduction available if the water produced by a water reclamation plant is used by the entity rather than sold?

A: The taxability of machinery and equipment is determined at the time of the sale or purchase. Therefore, if at the time the machinery or equipment is sold or purchased, the sale of the tangible personal property produced by the process (i.e., water) fulfilled a governmental function rather than a commercial function, even if it later fulfilled a business purpose, the deduction is not available under either the transaction privilege tax or use tax. Further, the taxability of repair and replacement parts is determined at the time of the sale or purchase of the repair or replacement parts.
Q: At the time the water reclamation plant is built and first put into service the water is sold. Is the vendor entitled to a deduction if the owner later decides to use the water for its own purposes?

A: If the machinery or equipment met the requirements for the deduction at the time that it was purchased the original deduction is not affected. However, the gross proceeds of sales of parts for subsequent repairs will not be eligible to receive the deduction, or exemption under use tax.

Further, if the machinery or equipment is incorporated into real property and the tangible personal property produced by the process fulfills a business purpose it is subject to tax under the prime contracting classification, unless it qualifies for a deduction from the tax base under A.R.S. § 42-5075(B)(7). On the other hand, if the machinery or equipment is incorporated into real property and the tangible personal property produced by the process fulfills a governmental function, it is subject to tax under the prime contracting classification regardless of A.R.S. § 42-5075(B)(7).