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ARIZONA TAX RESEARCH ASSOCIATION

ATRA SUPPORTS HB2404

Simplifying MRRA under Prime Contracting

Background

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 for commercial property if all of the following are true: 1) the contract amount is \$750,000 or less; 2) scope of the work is 40% or less of the existing square footage; and 3) scope of the work includes an expansion of 10% or less of the existing square footage. For either a residential or commercial contract, a 25% cushion was provided to accommodate changes to contracts that may initially qualify under MRRA without being pulled back into prime contracting.

MRRA simplified tax compliance for contractors that only work on MRRA projects; however, those complications were shifted to contractors involved in both MRRA and prime contracting activities. At the urging from this new hybrid of contractors, President Karen Fann introduced legislation in 2018 to eliminate MRRA and shift all contractors back into prime contracting. ATRA strongly opposed that effort since it would have reversed the progress made under MRRA. After much negotiation, legislation was agreed upon that simplified MRRA for commercial alteration projects to contract amounts of \$750,000 or less, regardless of square footage.

Based on a legislative appropriation requested by Rep. Regina Cobb in 2018, ADOR was required to commission a study to determine the noncompliance under prime contracting. That study was released in January 2019 and reported that noncompliance was as high as 19% between 2010 and 2016. Utilizing similar methods as the IRS and augmented by state-provided tax returns and audit results, the state lost approximately \$1 billion in tax revenue over that period of time. Specifically as it pertains to the use of exemption certificates in which there is no third-party information to substantiate against, the noncompliance rate can be as high as 63%.

ATRA supports HB2404 since it will greatly simplify prime contracting by allowing projects to remain under MRRA if the activity doesn't involve adding or expanding square footage. Furthermore, the provision to limit exemption certificates to one-year will help to reduce the current noncompliance in the system.