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ARIZONA TAX RESEARCH ASSOCIATION

ATRA SUPPORTS HB2535

Protecting Arizona's Machinery & Equipment Exemption

Background

During the 1996 legislative session, SB1280 was enacted to reverse a court decision that would have done immeasurable harm to economic development in Arizona. The passage of SB1280 was critical following the ruling in 1995 by the Arizona Court of Appeals in *Brink Electric Construction Co. v. Arizona Department of Revenue*, which at the time, changed the longstanding policy of the Arizona Department of Revenue (ADOR) regarding the tax treatment of the installation of exempt machinery and equipment (M&E) that did not become permanently attached to real property. Despite an existing ADOR regulation that required that the M&E become permanently attached, the Court of Appeals dismissed the permanent attachment test and concluded it was taxable contracting as long as the M&E remains “until the purpose to which the realty is devoted is accomplished.”

Left unchanged, Arizona would have been the only state in the country that exempted the purchase of M&E from the retail sales tax only to turn around and tax the installation costs of those items in new facilities through the contracting tax. Considering the significant costs associated with the installation of M&E for capital intensive manufacturers, this tax would have become a major impediment to economic growth in Arizona. In its final form, SB1280 exempted from the prime contracting tax the costs associated with installing, assembling, repairing or maintaining M&E that is also exempt from the TPT retail class that does not become “permanently attached” to the real estate.

The passage of SB1280 in 1996, which was clearly intended to return to a pre-Brink status in law, capped a long and pronounced battle between taxpayers and ADOR, that is, until now. In 2012, ADOR advanced a TPT ruling under prime contracting that reflects the holding of Brink Electric, completely ignoring the Legislature's actions under SB1280 in 1996 to overturn that decision. In the proposed ruling, ADOR states that simply bolting down exempt M&E into a concrete base is considered permanently attached and therefore subject to TPT under the prime contracting class.

Basis for ATRA's Support

HB2535 is an attempt to reverse the Department of Revenue's effort to change the longstanding treatment of the installation of exempt M&E under the prime contracting class. Under the proposal, HB2535 clarifies that the TPT on the cost of the installation, assembly, repair or maintenance of exempt M&E is exempt under the prime contracting class if the M&E is not permanently attached to the real property, particularly if the M&E has “independent functional utility” after installation. “Independent functional utility” is defined to mean that the M&E can independently perform its function without attachment to real property other than merely bolting down or burying the equipment to stabilize or protect the M&E.