



June 2, 2014

Ms. Christie Comanita  
Manager  
Tax Research & Analysis Section  
Arizona Department of Revenue  
1600 W. Monroe, Division Code 3  
Phoenix, Az 85007

Ms. Comanita,

In response to your request, representatives of CFMA (Construction Financial Management Association – with nearly 300 local Arizona members comprised of general contractors, subcontractors, suppliers and associated industry financial professionals), have reviewed the new tax legislation, and after lengthy discussion and review with other industry associations including the Arizona Chapter Associated General Contractors and the Arizona Builders' Alliance, offer the following commentary and thoughts:

**ISSUE A:**

The legislation (HB 2389) defines construction activities which are considered "maintenance, repair, replacement or alterations of existing property("MRRA")" to be subject to a point of sale tax vs. those construction activities "modifications" to be subject to the current gross receipts tax.

**POSITION/RECOMMENDATION:**

CFMA is concerned that the legislative definitions leave significant room for interpretation as to what is considered MRRA vs. Modification – and therefore how to apply the tax. Per Exhibit A, CFMA has identified some common contract scenarios which will provide examples ( a "playbook" if you will) of real world projects, allowing contractors to gain guidance on which tax application applies to their business. Once the Department reviews and provides guidance on these scenarios, our hope would be that this information would be available to contractors such that they can utilize this data to base their taxation reporting decisions.

**ISSUE B:**

ARS 42-5075 Section "O" of HB 2389 specifies that a "de minimis" amount of modification which is "essential" to the maintenance work activity will not subject the work to GRT reporting.

**POSITION/ RECOMMENDATION:**

CFMA would recommend that a 15% of original contract threshold be specified as the 'de minimis' level and the "essential" consideration not be of concern because it is too subjective. While the retail sales "de minimis" definition includes severability and isolation of material elements of sales and invoicing for the 'de minimus' rule to apply, this should NOT be a consideration for contractors, as the billing format often provides for material segregation on invoices, but would still be 'de minimus' in relation to the overall project – based on dollar value.

**TWO CONCERNS :**

1 – The de minimis rule would seem to need application "both directions". In other words, a modification project which has some maintenance elements would be reported under the gross receipts taxing method, so long as the maintenance portion was less than 15%.

2 - Once a job exceeds the de minimis level, how should the taxation be treated? It would be impractical, if not impossible, to have a single job that is partially subject to gross receipts taxing, and part subject to point of sale taxing. (please look at the "LEGISLATIVE SUGGESTIONS" below in regards to this concern)

**ISSUE C:**

Change Orders – are they taxed as independent taxable contracts, or as a continuation of the original contract for tax purposes?

**POSITION/ RECOMMENDATION:**

Change orders could number in the hundreds for certain projects, burdening both the contractor and DOR (upon audit) to determine the tax classification of these multiple changes. Additionally, the complexity to coordinate the tax or non-tax with subs/suppliers would be impossible to manage. Accordingly, CFMA's recommendation is to have all change orders follow the tax application of the original contract.

**ISSUE D:**

- 1 - Exemption forms: Form 5005 issued by general contractor to subcontractors;
- 2 - new prescribed exemption forms for contractors without TPT licenses.

**POSITION/ RECOMMENDATION:**

1 - CFMA recommends modification to existing Form 5005 to eliminate the option for "blanket, until revoked, or time prescribed" certificates, as under the new legislation each contract may be under a differing tax provision and will require a project specific form. With these options still available on the form, improper exemptions would be encouraged.

2 – this form is intended to be issued by the DOR for contractors who do not have a TPT number, but desire to work on a project subject to prime contracting. If such a contractor is required to have a contractor's license, we understand the Registrar requires them to have a TPT license. If so, this requirement is mute. However, if this requirement is waived and the subcontractor is no longer required to have a tax



number to obtain their license at the Registrar, then the exemption form is appropriate.

**ISSUE E:**

Material purchases have been discussed with the DOR as many contractors acquire materials regularly for a multitude of projects, not knowing if they will be applied to MRRA or Modification taxed projects.

**POSITION/ RECOMMENDATION:**

CFMA recommends that ALL material acquisitions be purchased as exempt for those contractors who do both MRRA and Modification work, and maintain their TPT licensing. Form 5000 would continue to be utilized for this purpose. Contractors that drop their TPT licenses would pay the tax upon purchase. If a MRRA project, and once the materials are incorporated into the project, the sales tax would be reported/paid on materials for those MRRA projects (and be reported at the location of the MRRA project, since contractors typically do not track/retain original purchase location for their material purchases); if a gross receipts tax project, the material remain exempt and taxes are paid under the current structure.

Note: this would require a legislative change, since current law requires reporting/paying tax at SELLER location – so we propose we coordinate for early 2015 enactment.

**ISSUE F:**

Bidding is of significant concern to CFMA and our respective companies. Due to the interpretational nature of the taxability of contracts, contractors may prepare bids with inappropriate tax calculations; thus placing some bidders at an advantage. And may later find their tax assumptions on the bid were wrong to begin with!

**POSITION/ RECOMMENDATION:**

Differing tax methodologies could result in major disruption to the construction bidding marketplace. Accordingly, the CFMA recommendation would be to require public agencies to identify in the bidding specifications the tax basis of the project. By establishing the taxability at bid time, it will assure bidding competition is placed on an equal playing field; and should the project be audited by the DOR, the basis for the taxation would be pre-determined and significantly simplify the audit process.

For private work, while a similar process would be great – CFMA is concerned that control of private work would be impractical – thus we recommend the industry be more proactive in working with our private clients to clarify tax methods. We would, however, request that the DOR be available to issue determination letters for projects if they are ‘grey’ as to the appropriate taxation – thus providing for tax pricing that is consistent among bidders.

**ISSUE G:**

ARS 42-5075 Section "O" of HB 2389 addresses gross income derived from the "owner . . . or person owning the improvements . . ."; which complicates the taxation determination – as contractors may not know the ownership structure of a particular project.

**POSITION/ RECOMMENDATION:**

CFMA believes the nature of the work should supersede the ownership structure. Accordingly, we recommend a change to "O" to remove the verbiage "with the owner of real property or the person owning the improvements to the real property"

Note: this would require a legislative change – so propose we coordinate for early 2015 enactment.

**LEGISLATIVE SUGGESTIONS:**

We have noted two items above that would require legislative action.

In the ALTERNATIVE, we might suggest that legislation be crafted that allows for those contractors who do smaller, maintenance type work to merely cancel their TPT license (or not acquire one for a new startup business) – and accordingly they would pay POS tax when they buy their materials. Other contractors (typically the larger contractors) would continue business as usual, reporting the tax under the current GRT system. This suggestion would literally eliminate most of the issues listed above. Just as importantly, would accomplish the "simplification" of the tax system for smaller contractors, which was a significant driver when this process began.

We sincerely hope these thoughts, ideas and concerns provide you some valuable feedback. CFMA, as well as the other endorsing associations, Arizona Chapter Associated General Contractors and the Arizona Builders' Alliance, stand ready to assist the Department of Revenue on this very critical issue.

Sincerely,



David Miller, CTP, CCIFP  
CFMA Valley of the Sun Chapter President

Endorsing Agencies :



David Martin  
Arizona Chapter Associated General Contractors

*Mark Minter*

Mark Minter  
Arizona Builders' Alliance





### Exhibit "A"

Examples of project scope for interpretation on how to apply the tax code changes between construction activities that are considered "maintenance, repair, replacement or alterations of existing property ("MRRA")" to be subject to point of sale vs. those construction activities considered as "modifications" still subject to the current gross receipts tax.

The potential exists for there to be confusion as to how to apply the tax code for projects that involve removing and replacing with new. The removal commonly involves demolition which has been included in the definition of "modification" but the work could be described as replacing which is included in the "MRRA" definition some examples :

- Example 1 : Remove cracked concrete sidewalks and ramps and replace with new concrete sidewalks and ramps.
- Example 2 : Removing and replacing electrical panels, transfer switches and motor controls, installing new wire and installing new conduit and altering existing conduit.
- Example 3 : Remodeling existing retail store, scope involves first demoing existing interior walls, and then remodeling existing store. If demo is considered "modification" and remodel is considered "MRRA" are two separate contracts required ?

The potential also exists for there to be confusion as to how to apply the tax code for projects that involve both repair & remodel, which is defined as "MRRA" and also involves new construction for example :

- Example 4 : Project involving both renovation of existing 2<sup>nd</sup> & 3<sup>rd</sup> floors of existing built out space and new construction on previously unoccupied 6<sup>th</sup> floor. The schedule of values for the contract pricing isn't broken down by floor or alterations vs. new construction, all inclusive price by scope of work ie plumbing, flooring, electrical, etc. Would this have to be broken down into two separate contracts ?
- Example 5 : Plumbing subcontractor performing plumbing repairs at school property involving multiple buildings, work performed at building A includes interior repairs and remodel of existing property, building B includes interior repairs and remodel of existing property building C includes remodel of existing and new building addition. Estimate is that 80% of the work is repair related and 20% related to new building addition. Would this need to be broken out in two separate contracts ?

- Example 6 : Plumbing subcontractor, original contract involved 80% repair work and 20% new building addition. Because of numerous change orders the amount of work performed at the new building addition grew to 60% of the scope of the work.

Heavy Highway construction brings with it a multitude of unique construction elements which create a challenge to distinguish between the MRRA definitions vs. the modification definition as modified under HB 2389. The following are examples of scopes of work from Heavy Highway projects, any Department guidance on how to apply the new tax legislation to these situations will help contractors with similar project scopes understand the DOR interpretation of the definitions and plan for appropriate tax obligations

- Example 7: Flood control project : The refurbishing of an existing flood retaining structure. The project scope consisted of raising the existing dam height, thereby increasing its size and retention capacity; the project scope also included clearing, cleaning, and adding water diversion materials in the already existing drainage channels.
- Example 8 : Newly completed test track for an automaker was found to be defective due to base course material contamination. The 'fix' required the contractor to completely demo the existing track, remove all pavement and base materials, and reconstruct entire track to the same specification, but with contaminant free base course material.
- Example 9 : Project scope consisted of improving 27 miles of existing roadway. The existing condition was a dirt road and upon project completion the road had new storm drain for drainage and a pavement structural section consisting of aggregate base and asphaltic concrete.
- Example 10 : The existing road failed due to a natural slide that buckled approximately  $\frac{3}{4}$ " miles of existing highway making it impassable. The project scope consisted of moving material from the slope above the road to the slope below the slide to shore up the slope so the road can be stabilized and repaired.
- Example 11 : A project categorized by ADOT as 'Pavement Preservation Project', which maintains the roadway because the asphaltic concrete is deteriorating with time and the contractor is improving it because the finished project involves building using the newest standards available such as using a new type of striping that didn't exist when the original roadway was built. The project scope involves demoing the existing asphaltic concrete by milling it up and hauling it off and replacing the old asphaltic concrete with new. The scope also includes improving the road by placing new course of AR-ACFC which both improves the road and repairs it.



The potential for confusion also exists regarding applying the new tax code for projects that involve “MRRRA” scopes of work for the owner of the property vs. the lessee for example:

- Example 12 : Project scope involves remodeling existing bathrooms due to water damage. If the client paying for the repairs to the leak and remodel to the damage is the lessee would it still qualify as subsection O, “MRRRA” ?
- Example 13 : 4,000 square foot renovation of existing interior construction. As an alteration of existing property would be defined as “MRRRA” and taxed under subsection O. If this project was performed for the lessee, how would the new tax law be applied? If the project was performed for an LLC that owns the property how would the new tax law apply? It is quite common that an LLC owns the property and the lessee that leases the property, while separate entities, are owned by the same individuals or members.
- Example 14 : Contract involving solar installation on a roof, the project scope includes new electrical panel. Installation of solar devices is tax exempt through 12/31/16. The electric panel is not tax exempt. If this project was for a homeowner, or owner of commercial property or lessee of commercial property, what classification would this work fall under? Would separate contracts need to be written for the solar installation and the new electrical panel ?
- Example 15 : Project scope includes replacing a condensing unit, relocating an existing condensing unit and installing a new condensing unit, pouring new concrete pads, running new electrical and new conduit for the relocated unit and the new unit and replacing a window. This client owns property and leases property. Would this same scope of work performed at clients property be taxed differently if performed at property where client is lessee ?