



Evaluating Mixed Construction Contracts

Often a construction contract will include maintenance, repair, replacement, and alteration (MRRRA) activities and modification activities. Depending on the percentage of the contract amount allocated to MRRRA and modification work, the contract could be wholly subject to the retail or equivalent transaction privilege tax (TPT) on materials only under the MRRRA rules or wholly subject to prime contracting TPT.

The purpose of this guideline is to enable taxpayers to determine how a construction contract should be taxed. The evaluation covered in this guideline should be done at the execution of the contract or presentation of the bid. Each contract should be evaluated separately. Note: this guideline may only be utilized where amounts for each type of construction activity is separately identified and where the construction activity is accurately described in the construction contract or attached documents (*e.g.*, bids, etc.)

1 Determine the Parts of the Contract

1a Determine the types of activities included in the contract:

Existing Property: Property that already includes some type of construction activity and on which some type of additional construction activity (adding to, changing, maintaining, etc.) will take place. For example, a homeowner decides to build a new block wall (no prior existing structure so not existing property). A month later the homeowner hires a different contractor to stucco and paint the wall. The second contract now involves existing property. See Transaction Privilege Tax Notice (TPN) 18-1, Scenario 9.

Maintenance: The upkeep of property or equipment. For example, topping off fluids in an HVAC system, re-staining a wood deck, or refinishing hardwood floors. See TPN 18-1, A2.

Repair: Returning existing property to a usable state from a partial or total state of inoperability or non-functionality. For example, fixing a leaky bathtub or shower (TPN 18-1, A2) or repairing windows and roof tiles due to hail damage by replacing them.

Replacement: Removal from service of existing property that is a: (i) *component*; or (ii) *system*; or (iii) type of *tangible personal property*, and replacement with another one that provides the: (i) same; or (ii) similar; or (iii) upgraded design or functionality; regardless of whether the existing component, system, or existing tangible personal property is physically removed from the existing property. For example, removal and replacement of a roof, flooring, a sprinkler system, or HVAC unit. See TPN 18-1, A2.

Component: One of the parts of a compound or complex whole; helping to make up the whole of something. A component may be a part of a system. For example, replacing faucets in a bathroom.

System: A regularly interacting or interdependent group of items (or components) forming a unified whole. For example, a roofing system includes shingles, lining, nails, etc., an HVAC system includes the heating/cooling unit, air filtration, furnace or boiler, ducting, etc., or plumbing system includes sink bowls, handles, faucets, pipes, etc.

Tangible personal property installed in existing property: Property installed into existing real property that can still be identified after installation, that does not lose its character and can be removed in essentially the same form. For example, machinery and equipment that is attached to the property.

Alteration: An activity or action that causes a direct physical change (*e.g.*, adding or expanding square footage) to existing property that cannot be classified as maintenance, repair, or replacement and that is under the following thresholds. For *residential* property (see Section 3) the alteration amount is less than 25% of the property's value as determined by the county assessor. For *commercial* property (see Section 3), the alteration amount is for less than \$750,000 (see TPN 18-1, A2). For example, a business hires a contractor to install a pump system in an existing building which did not previously exist. See TPN 18-1, Scenario 3. Alteration activities over these thresholds are categorized as modification activities.

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Modification: Activities encompassing “ground up” construction, grading and leveling ground, and wreckage or demolition, or other new contracting activity where none previously existed to the extent such activity cannot otherwise be characterized as maintenance, repair, replacement, or alteration (MRRRA) (see TPN 18-1, A3). For example, building a new home. Note: alteration activity exceeding certain thresholds (see above) is categorized as modification activity.

Residential: Existing property classified as class two property and that is used for residential purposes (see A.R.S. § 42-12002(1)(c)); class three property (see A.R.S. § 42-12003), or class four property (see A.R.S. § 42-12004). Please refer to the statutes for guidance.

Commercial: All other existing property not classified as residential (classes one, five, six, seven, eight, and nine). See A.R.S. §§ 42-12001, 42-12005, 42-12006, 42-12007, 42-12008, and 42-12009.

- 1b) Use the definitions above together with the charts in sections 2, 3, and 4 to help with this analysis.

2 Percentage and Contract Value

- 2a) Once the activities in the contract are determined, check if the charges associated with each type of activity covered by the contract have been itemized or are capable of itemization. The itemization itself need not be in the contract; backend records used to create the lump-sum bid may be employed. Demolition or wreckage and site preparation costs are considered part of the main project. See A.R.S. § 42-5075(R)(6). For example, if the project is considered to be a MRRRA project, the wreckage or demolition is also considered MRRRA (where the demolition is a necessary part of the project). Such wreckage or demolition is assigned to its own “bucket”; e.g., alteration demolition goes into the alteration bucket; replacement demolition goes into the replacement bucket.

Determine the percentage of each activity based on its represented value to each part of the contract, including both overhead and profits. NOTE: this exercise can only be performed if the contractual itemized charges can be property allocated to each type of activity. Each type of activity must meet the above definitions of the type of activity claimed. The Department reserves the right to reallocate the itemized charges if the contractual description or itemized charges are not consistent with the itemized charges included in this chart.

Maintenance	Repair	Replacement	Alteration	Modification	Total
%	%	%	%	%	100%
\$	\$	\$	\$	\$	\$

Comment: overhead and profit may be applied to each bucket based on their percentage.

- 2b) If the contract contains alteration activities, then complete 2c or 2d. If the contract contains modification activity but *does not* contain alteration activity, then skip to 4a. Note: if the contract relating to existing property only contains *one lump sum amount*, all of it should be allocated as alteration activity if any alteration activity is included in the contract.

If the contract does not contain alteration or modification then the project is considered to be a MRRRA project. No further analysis is necessary. TPT is paid at the point of purchase on all materials (measured by the materials cost) or the retail equivalent TPT is paid and sourced to the location of the contract when the materials are used.

- 2c) If **residential**, determine the property’s tax valuation as measured by the county assessor’s office.

OR

- 2d) If **commercial**, determine the alteration itemized charges.

Property Tax Value	Valuation Year
\$	

Alteration Itemized Charges
\$

3 Determine if Alteration Activity Exceeds the Threshold

NOTE

At the start of the job (before construction begins), the itemized charges for alteration activities should be calculated and compared with the statutory threshold. Itemized alteration charges which were initially below the threshold should be recalculated with each change order. (For change orders, see Section 5 below.)

3a Does the alteration itemized charges in the contract exceed the threshold of 25% of the **residential** property value (or cushion, if applicable – see section 5 below)?

Alteration Itemized Charges	Property Tax Value	Alteration as a Percentage of the Property Tax Valuation	Does the Alteration Itemized Charge Exceed 25% Threshold?
\$	\$	%	Yes/No

OR

3b Does the alteration itemized charge exceed \$750,000 (or cushion, if applicable – see section 5 below) on a **commercial** property?

Alteration Itemized Charge	Alteration Commercial Threshold	Does the Alteration Itemized Charge Exceed the \$750,000 Threshold?
\$	\$750,000	Yes/No

3c If the answer to 3a or 3b is YES, then the alteration itemized charge should be added to any modification itemized charge in the contract to determine whether the contract contains more than a *de minimis* amount of modification activity. See A.R.S. § 42-5075(O).

Reminder

At the start of the job (before construction begins), the itemized charges for alteration activities should be calculated and compared with the statutory threshold. Itemized alteration charges which were initially below the threshold should be recalculated with each change order. (For change orders, see Section 5 below.)

4 Determine if *De Minimis* Rules Apply

What does the *de minimis* rule mean? The gross proceeds of sales or gross income derived from an immaterial amount of modification activity does not subject the contract or any part of the contract to prime contracting TPT. Modification activity consisting of less than 15% of the contract value is considered *de minimis* or immaterial. See A.R.S. § 42-5075(O).

4a Determine if the *de minimis* rules apply using the alteration itemized charges and modification itemized charges.

Maintenance	Repair	Replacement	Alteration	Modification	Total
%	%	%	%	%	100%
\$	\$	\$	\$	\$	\$

Combined Modification Contract Itemized Charges

Combined Modification Contract Itemized Charges	Total Contract	De Minimis %
\$	\$	%

Divide the Combined Modification Contract Itemized Charges by the total contract value to obtain the *de minimis* percentage.

4b If the *de minimis* percentage is greater than 15%, then apply prime contracting TPT.

If the *de minimis* percentage is greater than 15%, the total contract (including all MRRA activity) is subject to prime contracting TPT.

4c If the *de minimis* percentage is less than 15%, then apply MRRA rules.

When the *de minimis* percentage in a construction contract is less than 15% the entire contract is treated as MRRA. I.E., TPT is paid at the point of purchase on all materials (measured by the materials cost) or the retail equivalent TPT is paid and sourced to the location of the contract when the materials are used. Where the contract is treated as MRRA, it is not subject to the prime contracting TPT.

5 Change Orders

Change orders: Change orders that directly relate to the scope of the original contract are treated the same as the original contract. Change orders not directly related are treated as a separate contract. See A.R.S. § 42-5075(R)(1)(a). Each change order treated as a separate contract should be analyzed in accordance with this document.

Change orders related to alteration contracts: At the start of the job (before construction begins), the itemized charges for alteration activities should be calculated and compared against the statutory threshold. Itemized alteration charges which were initially below the threshold should be recalculated with each change order.

Alteration 25% Cushion: A 25% cushion is allowed for itemized alteration changes which before construction started were reasonably believed to fall below the alteration threshold but then later exceed the threshold after construction starts due to the change orders. E.g., the commercial threshold with the added cushion is \$937,500 ($\$750,000 \times 25\% = \$187,500$). A cushion of \$187,500 is allowed which means the change orders in the contract can bring the total alteration amount to \$937,500 and still remain a commercial alteration contract. Although the alteration threshold for commercial projects is a fixed number (\$750,000), the residential threshold must be determined by the county assessor's value of EACH property. Additionally, the cushion for each property must also be calculated.

For residential property, the 25% cushion is in addition to the 25% threshold (i.e. instead of the \$750,000 threshold for commercial). For example, if the property value is \$200,000 as determined by the county assessor, the alteration threshold is \$50,000 ($\$200,000 \times 25\%$). A cushion of \$12,500 ($25\% \times \$50,000$) is allowed which means the change orders in the contract can bring the total contract amount to \$62,500 ($\$50,000 + \$12,500$) and still remain an alteration contract.

JOB ORDER CONTRACT

Job Order Contract: A job order contract is a contract for an indefinite quantity of construction. This could be for a specific duration (e.g., "all contracting needs for 5 years") or a general scope of services. As services are needed, specific work orders are issued under the terms of the primary contract. Each work order is analyzed on its own terms in order to determine whether the contract is a nontaxable MRRRA activity or taxable modification activity. See A.R.S. § 34-101(17) and TPN 18-1, page 14, Q27.