

ARIZONA TRANSACTION PRIVILEGE TAX PROCEDURE

TPP 00-2

Procedure for Factoring Transaction Privilege Tax and Related Taxes for Prime Contractors

(This procedure and TPP 00-1 supersede Arizona Sales Tax Ruling No. 3-0-84)

ISSUE:

This procedure provides guidance to persons subject to tax under the prime contracting classification, that factor their taxes from their gross proceeds of sales rather than separately stating the taxes.

APPLICABLE LAW:

Arizona Revised Statutes (A.R.S.) § 42-5002 *Exclusions from gross income, receipts or proceeds*, states in pertinent part, that "[f]or purposes of [transaction privilege and affiliated excise tax statutes] the total amount of gross income, gross receipts, or gross proceeds of sales shall be deemed to be the amount received, exclusive of ... [t]he taxes imposed by this chapter and chapter 6, article 3 of this title, sales or transaction privilege taxes imposed by municipalities in this state and sales or transaction privilege taxes imposed in this state by Indian tribes, if the Indian tribal tax is imposed with respect to sales by non-Indian or nonaffiliated Indian vendors to nonmembers of the tribe. A person who imposes an added charge to cover the tax levied by this article or which is identified as being imposed to cover transaction privilege tax shall not remit less than the amount so collected to the department."

A.R.S. § 42-5075 *Prime contracting classification*, imposes the transaction privilege tax on the business of prime contracting and dealership of manufactured buildings. The tax base for this classification is sixty-five per cent of the gross proceeds of sales or gross income derived from the business.

Model City Tax Code Section 250(b) authorizes factoring for purposes of city privilege taxes.

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DISCUSSION AND PROCEDURE:

Factoring is a mathematical process that extracts the tax from the seller's taxable receipts, when a tax amount was not separately identified to the purchaser. This method of tax computation is usually employed when the seller wishes to charge the purchaser a flat amount. An example of a common factoring situation for a prime contractor is a plumber who charges a flat sixty dollars for the replacement of a water pipe. While the prime contractor has the option of separately charging the tax, it is often more convenient to charge a flat price and factor the tax later. Any prime contractor may opt to factor transaction privilege tax and county excise tax.

Arizona cities also allow factoring for purposes of computing city privilege taxes, as authorized by Model City Tax Code Section 250(b). Often, contractors have identical amounts of taxable receipts that are subject to both state/county and city taxes. However, situations exist where city taxable receipts will be different from state taxable receipts. The transaction privilege tax statutes contained in Title 42 of the Arizona Revised Statutes govern the determination of a prime contractor's taxable receipts from which the applicable state transaction privilege tax and associated county excise taxes may be factored. Model City Tax Code provisions, which sometimes vary by city, govern the determination of taxable receipts from which the city privilege tax may be factored.

The Model City Tax Code's business classifications applicable to prime contractors, differ markedly in many respects from Title 42 statutes applicable to the same businesses. Therefore, a single transaction may produce different amounts of taxable receipts for city and state purposes. For prime contracting scenarios in which state/county and city taxes apply to different tax bases; algebraic equations may be utilized to determine the correct factored tax amounts. For some builders, a primary difference involved in factoring state/county and city taxes, is that while A.R.S. § 42-5075(B)(1) provides a deduction for the "sales price of land, which shall not exceed the fair market value", many cities either do not allow a deduction for land or allow the deduction only at cost rather than fair market value.

The following examples provide the algebraic equations to determine factored taxes for various scenarios associated with prime contracting. The department has also developed worksheets that may simplify the process of determining the correct state/county and city taxes, and the manner in which to complete the tax forms. The factoring worksheets for prime contractors are available from the department sections listed at the conclusion of this procedure, or may be downloaded from the department's website.

In the following examples, Gross Taxable Income (GTI) includes the price of the construction project, land, and "sales" taxes, less any deductions allowed by A.R.S. § 42-5075(B)(1) through (B)(12). Net Taxable Income (NTI) is 100% of GTI less the land value. [The tax base (65% of NTI less taxes), is calculated by the algebraic equation.] Unless otherwise noted, the examples are based on \$100,000 of GTI with a land value of \$20,000. The following tax rates and abbreviations are used in all examples:

State transaction privilege tax = 5% (.05)

County excise tax = .7% (.007)

City privilege tax = 2% (.02)

T = Total "Sales" Tax

ST = State Tax and County Tax

CT = City Tax

STR = State and County Combined Tax Rate Percentage

CTR = City Tax Rate Percentage

GTI = Gross Taxable Income

NTI = Net Taxable Income (GTI - land deduction amount)

SCTR = Combined State/County and City Tax Rates

CNTI = City Net Taxable Income (GTI - *City* land deduction amount)

Example 1:

Situation: State transaction privilege tax and county excise tax only; no city tax.

$$T = STR [.65 (NTI - T)]$$

$$T = .057 [.65 (NTI - T)]$$

$$T = .057 [.65 (\$80,000 - T)]$$

$$T = .057 (52,000 - .65 T)$$

$$T = 2,964 - .03705 T$$

$$1.03705 T = 2,964$$

$$T = \$2,858.11$$

This computation can produce an eight-digit decimal factor that can be used to determine the correct amount of tax for similar transactions. For this example, the decimal factor results from dividing the tax amount (T) by NTI. Therefore, the decimal factor is .03572637 ($2,858.11 \div 80,000 = .03572637$). This decimal factor can be used for any similar transaction, as long as the applicable tax rates are the same. If NTI equals \$90,000 rather than \$80,000, the computation of the factored taxes is simplified:

$$\text{Multiply NTI by the decimal: } \$90,000 \times .03572637 = \$3,215.37$$

$$\text{Proof: } .65 (\$90,000 - 3,215.37) \times 5.7\% = \$3,215.37 \text{ factored tax}$$

Factoring Tables that provide predetermined decimal factors for specific tax rates are available from the department or on the department's website, at the addresses listed at the conclusion of this procedure. However, please ensure that the decimal factor that you utilize applies to the correct tax rate and prime contracting scenario.

Example 2:

Situation: State transaction privilege tax, county excise tax, and city tax.

City land deduction amount is the same as state land deduction amount.

$$T = \text{SCTR} [.65 (\text{NTI} - T)]$$

$$T = (\text{STR} + \text{CTR}) [.65 (\text{NTI} - T)]$$

$$T = (.057 + .02) [.65 (\text{NTI} - T)]$$

$$T = .077 [.65 (\text{NTI} - T)]$$

$$T = .077 [.65 (\$80,000 - T)]$$

$$T = .077 (52,000 - .65 T)$$

$$T = 4,004 - .05005 T$$

$$1.05005 T = 4,004$$

$$T = \$3,813.15$$

State/county portion of T: $STR \div SCTR \times T$

$$(.057 \div .077 = .74026): .74026 \times 3,813.15 = \$2,822.72$$

City portion of T: $CTR \div SCTR \times T$

$$(.02 \div .077 = .25974): .25974 \times 3,813.15 = \$ 990.43$$

Proof: Sum of portions $2,822.72 + 990.43 = \underline{\$3,813.15}$

For similar transactions with same tax rate:

State/county decimal factor to apply to NTI: $2,822.72 \div 80,000 = .035284$

City decimal factor to apply to NTI: $990.43 \div 80,000 = .01238037$

Example 3:

Situation: State transaction privilege tax, county excise tax, and city tax.

City does not allow a land deduction.

$$T = ST + CT$$

$$T = STR [.65 (NTI - T)] + CTR [.65 (CNTI - T)]$$

$$T = .057 [.65 (\$80,000 - T)] + .02 [.65 (\$100,000 - T)]$$

$$T = .057 (52,000 - .65 T) + .02 (65,000 - .65 T)$$

$$\text{step 3} \rightarrow T = 2,964 - .03705 T + 1,300 - .013 T$$

$$T = 4,264 - .05005 T$$

$$1.05005 T = 4,264$$

$$T = \underline{\$4,060.76}$$

After completing the Example 3 computation, we can replace the variable "T" in step 3 of the

above example with the actual total tax amount, in order to calculate the separate state/county and city tax amounts.

$$T = ST + CT$$

$$\text{step 3 (above)} \rightarrow T = (2,964 - .03705 T) + (1,300 - .013 T)$$

$$ST = 2,964 - .03705 T$$

$$ST = [2,964 - .03705 (4,060.76)] = \$2,813.55$$

$$CT = 1,300 - .013 T$$

$$CT = [1,300 - .013 (4,060.76)] = \$1,247.21$$

$$\text{Proof: } ST + CT = T: \$2,813.55 + 1,247.21 = \underline{\$4,060.76} (T)$$

For similar transactions with same tax rate: A decimal factor does not work for similar transactions because of the different tax bases. Either the above computation must be performed or the department's worksheets may be used.

Example 4:

Situation: State transaction privilege tax, county excise tax, and city tax.

City land deduction amount is allowed only at cost, rather than the fair market value. The cost of the land is \$10,000.

$$T = ST + CT$$

$$T = STR [.65 (NTI - T)] + CTR [.65 (CNTI - T)]$$

$$T = .057 [.65 (\$80,000 - T)] + .02 [.65 (\$90,000 - T)]$$

$$T = .057 (52,000 - .65 T) + .02 (58,500 - .65 T)$$

$$\text{step 3} \rightarrow T = 2,964 - .03705 T + 1,170 - .013 T$$

$$T = 4,134 - .05005 T$$

$$1.05005 T = 4,134$$

$$T = \underline{\$3,936.96}$$

After completing this computation, we can replace the variable "T" in step 3 of the above example with the actual total tax amount, in order to calculate the separate state/county and city tax amounts.

$$T = ST + CT$$

$$\text{step 3 (above)} \rightarrow T = (2,964 - .03705 T) + (1,170 - .013 T)$$

$$ST = 2,964 - .03705 T$$

$$ST = [2,964 - .03705 (3,936.96)] = \$2,818.14$$

$$CT = 1,170 - .013 T$$

$$CT = [1,170 - .013 (3,936.96)] = \$1,118.82$$

$$\text{Proof: } ST + CT = T: \$2,818.14 (ST) + 1,118.82 (CT) = \underline{\$3,936.96} (T)$$

For similar transactions with same tax rate: A decimal factor does not work for similar transactions because of the different tax bases. Either the above computation must be performed or the department's worksheets may be used.

Additional note:

For transaction privilege tax and county excise tax purposes, a deduction for a bad debt is allowed for a sale previously reported. Taxpayers using a factoring method to determine a tax amount at the time of initially reporting the tax, must factor out this tax amount before deducting a bad debt expense at a later date. This is necessary in order to adjust the bad debt deduction to the true sales price less the factored tax.

To obtain factoring tables or Contracting Tax Factoring Worksheets and examples, please contact either of the following department sections, or access the department's website:

Taxpayer Information and Assistance Section

Arizona Department of Revenue
1600 West Monroe
Phoenix, AZ 85007

(602) 255-2060 or (800) 843-7196

Transaction Privilege Tax and Use Tax Audit Section

Arizona Department of Revenue
1600 West Monroe
Phoenix, AZ 85007

(602) 542-4656

Arizona Department of Revenue Website: <http://www.azdor.gov>

Mark W. Killian, Director

Signed: February 10, 2000

Explanatory Notice

The purpose of a tax procedure is to provide procedural guidance to the general public and to department personnel. A tax procedure is a written statement issued by the department to assist in the implementation of tax laws, administrative rules, and tax rulings by delineating procedures to be followed in order to achieve compliance with the law. Relevant statute, case law, or administrative rules, as well as a subsequent procedure, may modify or negate any or all of the provisions of any tax procedure. See GTP 96-1 for more detailed information regarding documents issued by the Department of Revenue.