

ARIZONA DEPARTMENT OF REVENUE

ARIZONA TRANSACTION PRIVILEGE TAX RULING TPR 92-4

(On 8/27/2020 the statute and rule references were updated to reflect the new numbers. See footnotes for details. No substantive changes were made.)

This substantive policy statement is advisory only. A substantive policy statement does not include internal procedural documents that only affect the internal procedures of the agency and does not impose additional requirements or penalties on regulated parties or include confidential information or rules made in accordance with the Arizona administrative procedure act. If you believe that this substantive policy statement does impose additional requirements or penalties on regulated parties you may petition the agency under Arizona Revised Statutes § 41-1033 for a review of the statement.

ISSUE:

Whether raw materials or component parts which were exempt from the transaction privilege tax when purchased are subject to the use tax when used in defective products which are discarded or destroyed.

APPLICABLE LAW:

A.R.S. § 42-5155(A)¹ levies an excise tax on the storage, use or consumption in this state of tangible personal property purchased from a retailer, as a percentage of the sales price. Every person storing, using or otherwise consuming tangible personal property in this state is liable for the use tax.

A.R.S. § 42-5155(B)² imposes the use tax on any purchaser which purchased tangible personal property for resale but subsequently uses or consumes the property.

A.R.S. § 42-4159(A)(4)³ exempts from the use tax tangible personal

¹ This ruling originally cited A.R.S. § 42-1408.A which was renumbered as A.R.S. § 42-5155(A).

² This ruling originally cited A.R.S. § 42-1408.B which was renumbered as A.R.S. § 42-5155(B).

³ This ruling originally cited A.R.S. § 42-1409.A.4 which was renumbered as A.R.S. § 42-5159(A)(4).

property which directly enters into and becomes an ingredient or component part of any manufactured, fabricated or processed article, substance or commodity for sale in the regular course of business.

A.R.S. § 42-4159(A)(4)⁴ exempts from the use tax raw materials and component parts purchased which become an integral part of a manufactured product. They are considered purchases for resale.

DISCUSSION:

Raw materials and component parts must be purchased by manufacturers in order to produce finished products. Most manufacturers have quality control procedures to ensure that products which do not meet quality control standards are not sold to the consumer. The products identified as defective are then discarded or destroyed by the manufacturer.

The question has arisen as to whether raw materials or component parts used in defective products and subsequently discarded or destroyed are subject to use tax as property consumed within the state.

The Arizona transaction privilege tax and use tax are complementary taxes. Goods which were purchased from a retailer under a resale exemption and which are subsequently consumed by the purchaser for their own use are subject to the use tax. A.R.S. § 42-5155(B)⁵; *People of Faith, Inc. v. Arizona Department of Revenue*, 161 Ariz. 514, 779 P.2d 829 (Tax 1989).

Raw materials and component parts which are used in products which do not meet quality control standards and which are subsequently discarded or destroyed have not been self-consumed by the manufacturer if the raw materials and component parts are not otherwise used. The theory is that production involves certain losses and that defective items removed from production and discarded are not actually self-consumed by the taxpayer if the items are not otherwise used.

⁴ This ruling originally cited A.A.C. R15-5-2314 which was renumbered as A.A.C. 15-5-2321 and later allowed to expire because it was repetitive of A.R.S. § 42-4159(A)(4).

⁵ See footnote 2.

CONCLUSION AND RULING:

Raw materials and component parts used in products which are discarded or destroyed as defective have not been converted to the manufacturer's own use. Destruction of goods purchased for resale is not a taxable use when the goods are not suited for their intended purpose and the purchaser disposes of the goods rather than marketing or otherwise using them.

Property which is discarded or destroyed by a manufacturer because it does not meet quality control standards, and is not otherwise used, is not subject to the use tax.

Example:

A manufacturer takes a product off the production line and uses it in the quality control system to determine if the products coming off the line meet specification. The testing process, by its nature, destroys the product that was used for the test. This product is subject to the use tax because it was used for testing.

Example:

Every fourth product is tested to determine if products meet specification as part of the quality control process for an assembly line manufacturer. Of these items approximately 10% are determined not to meet the standards set. These items are disposed of and not used for any other purpose. No use tax is assessed on these defective parts.

Paul Waddell, Director
Signed August 14, 1992