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PRIVATE TAXPAYER RULING LR05-004

June 14, 2005

The Department issues this private taxpayer ruling in response to your letter of January 5, 2004, in which you request a ruling on behalf of your company . . . (“Taxpayer”) . . . on the applicability of Arizona transaction privilege tax under several unique factual circumstances and on specific business activities engaged in by Taxpayer. You also submitted supplemental letters to your January 5 request on February 18 and March 22, 2004, responding to the Department’s request for further clarification on a number of substantive areas.

Statement of Facts:

The following facts are excerpted from your January 5 letter:

[Taxpayer] has recently been contacted by representatives of [Subsidiary Manufacturer], a division of [Parent Manufacturers], pertaining to the taxability of certain contractual projects being performed by [Taxpayer] for [Subsidiary Manufacturer]’s beverage manufacturing facility located in [City], AZ.

[Taxpayer] is a registered contractor in the State of Arizona . . . and performs a variety of projects at [Subsidiary Manufacturer]’s manufacturing facility. Recent projects include work performed to repair and install manufacturing machinery and equipment used directly in the manufacturing process, repair and installation of pollution control equipment, bulletin/billboard installation, as well as other real property projects.

Most of the work performed by [Taxpayer] is done by bid and is billed as construction activity. The bids are derived by assessing the cost of each component of the project for the work being performed. When billing [Subsidiary Manufacturing] for the contract, labor and materials are generally not billed as separate items on an invoice. Since [Taxpayer] is registered as a licensed contractor in the State of Arizona, the prime contractor’s rate for transaction privilege (sales) tax (65% of the gross proceeds of sales) is charged on contracts with [Subsidiary Manufacturer].

In your March 22 letter supplementing the January 5 ruling request, you provided further information on Taxpayer’s abovementioned business activities:

Invoice No.	Scope of Work
2264	pH probe installation – connect probe to pH meter in plant effluent monitoring station located outside plant perimeter in manhole. Records pH of plant effluent to sewer line.
2270	Weld valve bodies and main bowl manifold on existing process water system. Feeds water into product line.

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Invoice No.	Scope of Work
2340	Furnish and install all piping and equipment for clean-in-place system. System sterilizes all equipment in the area during line closings and product change outs. Installation included welding, pipefitting, and equipment setting and was mounted to the floor and to other equipment by weld and bolts.
2422	Furnish and install cap feeder. Mounted to floor and other existing equipment with bolts and welds. Feeds bottle caps into bottle capper.
2426	Steam line repair, pump cover modification and add nipple to chemical line by weld to existing equipment. Steam heats up product water for pasteurization.
2427	Furnish and install capper platforms and filler platform. Floor mounted with bolts and welded and bolted to existing equipment. These are equipment operator platforms.
2472	pH probe installation – connect probe to pH meter inside plant effluent monitoring station located outside plant perimeter in manhole. Records pH of plant effluent to sewer line.
2486	Replaced 3” tee in the line 2 blend room. Welded into existing process piping. (Piping carries product water)
2494	pH probe installation – connect probe to pH meter in plant effluent monitoring station located outside plant perimeter in manhole. Records pH of plant effluent to sewer line.
2582	Replace the existing 10” cast iron P-Trap located in the RO room with a 10” PVC P-Trap. Sewer line for RO wastewater set underground in concrete. Installation included sawcutting concrete, excavation, reinstallation and new concrete. “Reject” water (water not used or not up to standard) flows into the sewer from these drains.
2584	Remove 4410 pump and install 326 supply pump. Bolt pump into place and weld piping back to pump. Pump move water used to cool down bottles after they are filled with product.
2585	Change order for clean-in-place horizontal rinser bars down about 2” and plug and reweld threadlets on rinser bars, cut conveyor bars down 4” and reweld. System sterilizes all equipment in the area during line closings and product change outs.
2592	Installation of stainless steel cover on depallatizer line 1 & 2. Depallatizer removes bottles from pallets and places them in the process line. Cover welded in place.
2595	Leak investigation and repairs in boiler room. Involved sawcut of concrete, excavation of effluent wastewater (sewer) line, repairs, and new concrete. (Line carries process wastewater from the boiler room)
2598	20,000 gallon tank overflow pipe. RO water storage tank connection by welding. Carries excess purified water from the storage tank to the floor where it drains into the sewer.
2730	[R]eplace 3” ferrule by welding into place on existing piping. Piping carries product water.
2738	[B]lend Room #3 pump piping welded to existing equipment. Piping carries product water inside blend room.
2739	Installation of eight unistrut brackets and three 2” schedule 80 PVC lines from RO unit to 3” header from north to south. PVC glued together and brackets mounted to floor and walls with bolts. Pre-water treatment prior to RO system. Piping carries city “raw” water into RO purification unit.

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Invoice No.	Scope of Work
3334	Installation of 4 each 1" stainless steel welded couplings with nipples and ball valves in the existing dual media filters' stainless steel piping. Pre-water treatment prior to RO system. Carries water into or out of the raw water filtration system.
3335	Install stainless steel repipe, supply and return piping at the dual media filters. Pre-water treatment prior to RO system. Welded. Carries water into or out of the raw water filtration system.
3356	Installation of 2-6" valves at the raw water system. Pre-water treatment prior to RO system. Welded. Carries water into or out of the raw water filtration system.
3459	Furnish and install line 3 blend tank B agitator via welding and wood screws. Mixes product.
3498	[T]emporary installation of two RO units. Temporary water treatment system. One RO unit mounted on skid, the other in trailer. Provide temporary units and make connections to existing process and raw water by weld. Temporary product water purification systems.
3651	Batch water reheat. Process cooling system for product water. Connected to existing process by welding, piping, pumps, etc.
3705	Batch water reheat. Process cooling system for product water. Connected to existing process by welding, piping, pumps, etc.
3749	Installation of TPM billboards by bolting and screwing into place on walls. Billboards contain process and safety information for equipment operators.
3750	Reroute CIP hot fill supply line to accommodate batch water project. Reweld pipe and connect to equipment by weld and bolt. Clean-in-place system cleans product line during shut downs or product change outs.
3751	Reroute secure permeate flush line to support batch water project. Reweld pipe and connect to equipment by weld and bolt. Flushes line that carries the highly purified product water after a batch of product is made.
3829	Change Order No. 2 to Batch Water Reheat Project. Process cooling system for product water. Connected to existing process by welding, piping, pumps, etc.
3894	Installation of 4 and relocation of 1 TPM billboards by bolting and screwing into place on walls. Billboards contain process and safety information for equipment operators.
4031	pH probe installation – connect probe to pH meter in plant effluent monitoring station located outside plant perimeter in manhole. Records pH of plant effluent to sewer line.

Your Issues:

In your January 5 request, you indicated that you wish the Department to issue a ruling on whether Taxpayer's gross proceeds of sales or gross income derived from the abovementioned contracting activities are exempt from transaction privilege tax under the prime contracting classification, pursuant to the Arizona Revised Statutes ("A.R.S.") § 42-5075(B)(7) exemption.

Your Positions:

Your position is that gross proceeds of sales or gross income derived from the abovementioned contracting activities are not subject to transaction privilege tax under the prime contracting classification because all activities constitute the installation, assembly,

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repair, or maintenance of machinery, equipment, or other tangible personal property that is deducted from the tax base of the retail classification pursuant to A.R.S. § 42-5061(B)(1). You further assert that purchases of the abovementioned machinery and equipment are exempt from Arizona use tax.

Conclusion and Ruling:

In summarizing the request's description of contracting work that Taxpayer performed at the City facility, the activities and various machinery and equipment at issue in this ruling are as follows:

1. *Reverse osmosis (RO) water purification system:* Installation (e.g., gluing piping together, mounting to floor and walls with bolts, welding) of mounting brackets, piping, valves, couplings, storage tanks, and related components that carry untreated or "raw" water to the RO water purification machinery and equipment and that carry the purified product water on through the manufacturing process. [Invoice Nos. 2270, 2486, 2730, 2738, 2739, 3334, 3335, and 3356]
2. *Temporary RO units:* Temporary installation (i.e., mounting on skid, mounting in trailer, welding) of two RO units used to purify water. [Invoice No. 3498]
3. *Overflow pipe:* Installation (i.e., welding) of tank overflow pipe that carries excess product water from storage tank to floor, where it drains into the sewer. [Invoice No. 2598]
4. *P-trap:* Replacement and installation (e.g., sawcutting concrete, excavation, reinstallation, new concrete) of underground "P-trap" for draining "reject" water (i.e., excess purified water or water that is not up to manufacturing standards) into the sewer. [Invoice No. 2582]
5. *Steam line:* Repair, modification, and installation of steam line equipment and related components used in heating up product water for pasteurization. [Invoice No. 2426]
6. *Agitator:* Purchase and installation (i.e., welding, wood screws) of an agitator, which is used to mix products. [Invoice No. 3459]
7. *Equipment operator platforms:* Purchase and installation (i.e., mounting to floor with bolts and welded and bolted to existing equipment) of operator platforms. [Invoice No. 2427]
8. *Billboards:* Installation (i.e., by bolting and screwing into place on walls) of billboards used for conveying process and safety information to equipment operators. [Invoice Nos. 3749 and 3894]
9. *Depallatizer:* Installation (i.e., welding) of the cover to a depallatizer, a machine that removes bottles from pallets and places them in the process line. [Invoice No. 2592]

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10. *Bottle cap feeder*: Purchase and installation (*i.e.*, mounting to floor and other existing equipment with bolts and welds) of bottle cap feeder, which feeds bottle caps into the bottle capper machine. [Invoice No. 2422]
11. *Process cooling system*: Removal and installation (*i.e.*, bolting into place, welding) of piping, pumps, and related components used to move water used to cool down bottles and product water after they are filled with product. [Invoice Nos. 2584, 3651, 3705, and 3829]
12. *Clean-in-place (CIP) system*: Purchase, installation (*i.e.*, welding, pipefitting, and mounting to floor and other equipment by weld and bolts), and modifications (*e.g.*, lowering, rewelding, cutting, rerouting piping) of piping and equipment for a network of pipes, sprayers, etc. called a CIP system that flushes out, cleans, and sterilizes the machinery and equipment used in the manufacturing. [Invoice Nos. 2340, 2585, 3750, and 3751]
13. *Sewer line*: Repairs (*e.g.*, concrete sawcutting, excavation, repairs, new concrete) to an underground sewer line carrying process wastewater from the boiler room. [Invoice No. 2595]
14. *pH probes*: Installation of pH probes that monitor wastewater moving from the plant to the municipal sewer line. [Invoice Nos. 2264, 2472, 2494, and 4031]

A.R.S. § 42-5075(B)(7) provides that “permanent attachment” to realty means at least one of the following:

- a. To be incorporated into real property.
- b. To become so affixed to real property that it becomes a part of the real property.
- c. To become so attached to real property that removal would cause substantial damage to the real property from which it is removed.

If equipment otherwise qualifying for an exemption under A.R.S. §§ 42-5061(B) or 42-5159(B) also meets one of the three parts of this test, the income derived from the installation does not qualify for this deduction from the prime contracting tax base.

Considering the three prongs of the A.R.S. § 42-5075(B)(7) permanent attachment definition individually:

- To become incorporated into real property, tangible personal property would have to be combined into or imbedded in the real property so as to be made part of the real property.
- Affixation to real property refers to the law of fixtures. The longstanding common law of fixtures employs a three-prong test to determine whether tangible personal property

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constitutes real property or retains its identity as personalty. For chattel to become a fixture and be considered real property, three requisites must unite:

1. There must be an annexation to the realty or something appurtenant thereto.
2. The chattel must have adaptability or application as affixed to the use for which the real estate is appropriated.
3. There must be an intention of the party to make the chattel a permanent accession to the freehold. Under normal circumstances, the Department will look at objective indicia of intent when making this determination.

See, e.g., *Fish v. Valley Nat'l Bank*, 167 P.2d 107, 111 (Ariz. 1946); see also *Sulphur Springs Valley Elec. Co-op., Inc. v. City of Tombstone*, 401 P.2d 753, 758-59 (Ariz. Ct. App. 1965).

The Court of Appeals' decision in *Arizona Department of Revenue v. Arizona Outdoor Advertisers, Inc.*, 41 P.3d 631 (Ariz. Ct. App. 2002), adds an additional dimension to the three-part analysis with the "reasonable person" test, which the court held applies "in the context of characterizing property as real or personal for tax purposes. The focus of a reasonable person inquiry is, "Would a reasonable person, after considering all the relevant circumstances, assume that the item in question belongs to and is a part of the real estate on which it is located?" 41 P.3d at 637-38. To wit, the court stated:

The . . . test . . . maintains the preferred standard of objective measurement and corrects for the major shortcomings of the [three-part] *Teaff* [fixtures] test [from *Teaff v. Hewitt*, 1 Ohio St. 511 (1853)], namely artificial restriction of the test to the time of original annexation, unjustifiable confinement of the process to just the three *Teaff* factors, and unwarranted exclusion of evidence of subjective intent, either of the original annexor or of the parties to an agreement regarding the property. . . . While *Teaff's* three factors will no longer limit the inquiry, they will continue to play a major role. In fact, annexation will probably continue as the triggering event for most fixtures inquiries.

Id. at 638. While *Arizona Outdoors'* reasonable person test should be considered in an A.R.S. § 42-5075(B)(7) analysis, it is also important to note that the Court of Appeals was clarifying the broader scope of "improvements" vis-à-vis "fixtures," in that an improvement encompasses everything that permanently enhances the value of real property for general use, while fixtures constitute a subset of the broader category of "improvements." *Id.* at 634.

- The substantial damage part of the test is self-explanatory.

Note that the A.R.S. § 42-5075(B)(7) exemption applies to all tangible personal property that is exempt under an A.R.S. § 42-5061(B) or § 42-5159(B) exemption, as some of the machinery and equipment at issue are not qualifying machinery and equipment under the

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A.R.S. § 42-5061(B)(1) or § 42-5159(B)(1) exemption but are nevertheless exempt under another subsection B exemption.

Pursuant to *Arizona General Tax Procedure* GTP 01-3, the Department generally will not issue a private taxpayer ruling if the question involves a fact-intensive issue. Most determinations of whether particular pieces of machinery and equipment are permanently attached to realty require a weighing of numerous factors and variables that cannot adequately be addressed in the format of a private taxpayer ruling. Consequently, regarding contracting activities subject to tax under the A.R.S. § 42-5075 prime contracting classification, the following ruling will account for those activities discussed in the facts *supra* that clearly fall outside the scope of the subparagraph (B)(7) exemption:

Accordingly, the Department rules as follows:

1. The sale or purchase of the following machinery and equipment are exempt under one or more A.R.S. § 42-5061(B) or § 42-5159(B) exemptions such that the income attributable to the purchase of the items by Taxpayer would be deductible under A.R.S. § 42-5075(B)(9):
 - a. *RO water purification system,*
 - b. *Temporary RO units,*
 - c. *Overflow pipe,*
 - d. *P-trap,*
 - e. *Steam line,*
 - f. *Agitator,*
 - g. *Depallatizer,*
 - h. *Bottle cap feeder,*
 - i. *Process cooling system,*
 - j. *Sewer line,* and*
 - k. *pH probes.*

* The sewer line at issue in this ruling is exempt insofar as it is machinery and equipment used directly in Subsidiary Manufacturer's manufacturing and processing operations at the plant by carrying process wastewater.

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2. The sale or purchase of the following machinery and equipment are not exempt under any A.R.S. § 42-5061(B) or § 42-5159(B) exemption, such that the income attributable to the purchase of the item by Taxpayer would not be deductible under A.R.S. § 42-5075(B)(9):
 - a. *Equipment operator platforms*: Based on the descriptions provided, billboards fall outside the scope of the A.R.S. § 42-5061(B)(1) exemption, because they are ancillary and nonintegral to Subsidiary Manufacturer's actual manufacturing and processing operation. Furthermore, the platforms do not appear to qualify under any other A.R.S. § 42-5061(B) exemption.
 - b. *Billboards*: Based on the descriptions provided, billboards fall outside the scope of the A.R.S. § 42-5061(B)(1) exemption, because they are ancillary and nonintegral to Subsidiary Manufacturer's actual manufacturing and processing operation. Furthermore, the billboards do not appear to qualify under any other A.R.S. § 42-5061(B) exemption.
 - c. *Clean-in-place system/flush line*: Piping, equipment, rinsers bars, and various components of the clean-in-place system/flush line clean, flush out, and sterilize machinery and equipment used in the beverage manufacturing operation, but are ancillary to the operation because it is used either before or after the actual manufacturing begins and ends (*i.e.*, during line closings and product change-outs) and not when the manufacturing occurs. Moreover, because it is not used during the actual manufacturing of Subsidiary Manufacturer's products, the system does not appear essential or integral to that manufacturing operation, as property exempt under A.R.S. § 42-5061(B)(1) must be. See *Ariz. Dep't of Revenue v. Capitol Castings, Inc.*, 88 P.3d 159, 162-63 (Ariz. Ct. App. 2004); *Duval Sierrita Corp. v. Ariz. Dep't of Revenue*, 88 P.2d 1098, 1104-05 (Ariz. Ct. App. 1977). The machinery and equipment thus fall outside the scope of the A.R.S. § 42-5061(B)(1) exemption, and do not appear to qualify under any other A.R.S. § 42-5061(B) exemption.
3. Taxpayer's gross proceeds of sales or gross income derived from contracting activities performed on the following machinery and equipment, as such work and personalty have been described by Taxpayer, is not exempt under A.R.S. § 42-5075(B)(7):
 - a. *P-trap*: The p-trap is installed by connecting it to wastewater piping below the ground and securing it into the concrete floor of the realty. It is attached in such a manner as to be affixed such that it becomes part of the realty (*i.e.*, it fulfills the three-part fixtures test and would reasonably be perceived to be part of the realty) and as to cause substantial damage to the realty if removed.

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- b. *Sewer line*: Taxpayer's contracting activities associated with the sewer line—concrete sawcutting, excavation, and pouring of new concrete—would appear to be specifically excluded from the A.R.S. § 42-5075(B)(7) exemption, because they consist of the "development of, or modification to, real property in order to facilitate the installation, assembly, repair, maintenance or removal of" the tangible personal property. Also, the sewer line itself is both attached in such a manner as to become so affixed to the real property that it becomes a part of the real property, and so attached that removal would cause substantial damage to the real property from which it is removed. It also would reasonably be assumed to belong to and be a part of the real estate on which it is located upon installation. Consequently, although components of the sewer line may be exempt under A.R.S. § 42-5061(B)(1) as being used directly during and in the beverage manufacturing operation and as being integral to the operation, Taxpayer's gross proceeds of sales or gross income derived from contracting activities associated with its installation is not exempt under A.R.S. § 42-5075(B)(7).

For reasons provided above and generally discussed in GTP 01-3, Taxpayer's activities and tangible personal property not specifically addressed in these rulings are too fact-intensive for the Department to make a definitive ruling.

The conclusions in this private taxpayer ruling do not extend beyond the facts presented in your letters of January 5, February 18, and March 22, 2005.

This response is a private taxpayer ruling and the determination herein is based solely on the facts provided in your request. The determinations are subject to change should the facts prove to be different on audit. If it is determined that undisclosed facts were substantial or material to the Department's making of an accurate determination, this taxpayer ruling shall be null and void. Further, the determination is subject to future change depending on changes in statutes, administrative rules, case law, or notification of a different Department position.

The determinations in this private taxpayer ruling are only applicable to the taxpayer requesting the ruling and may not be relied upon, cited, nor introduced into evidence in any proceeding by a taxpayer other than the taxpayer who has received the private taxpayer ruling.