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Governor

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Director

## TAXPAYER INFORMATION RULING LR16-009

August 24, 2016

Thank you for your letter dated November 30, 2015 requesting a taxpayer information ruling on behalf of your undisclosed client, ("Taxpayer"). Specifically, you requested a ruling as to the applicability of Arizona's transaction privilege tax ("TPT") to provision and installation of solar energy devices. Pursuant to Arizona Revised Statutes (A.R.S.) § 42-2101, the Department may issue taxpayer information rulings to taxpayers and potential taxpayers on request.

### ISSUE:

1. Whether Taxpayer's gross receipts attributable to providing and installing the solar collector components are deducted from the tax base pursuant to A.R.S. 42-5075(B)(13) or any other provision of law?
2. Whether the revenue attributable to the main posts be deducted from the tax base pursuant to A.R.S. 42-5075(B)(13) or any other provision of law, even though the height and weight of such units mandate the specification of oversized posts and tables?
3. Whether Taxpayer's gross receipts attributable to all activity pertaining to the preparation of the foundations for the main posts supporting solar modules be deducted from the tax base pursuant to A.R.S. 42-5075(B)(13) or any other provision of law?
4. Whether Taxpayer's gross receipts attributable to repairing areas after the installation of the main posts be deducted from the tax base pursuant to A.R.S. 42-5075(B)(13) or any other provision of law?
5. Whether Taxpayer's gross receipts attributable to the provision and installation of fencing to protect the inverter be deducted from the tax base pursuant to A.R.S. 42-5075(B)(13) or any other provision of law?
6. Whether the overhead costs to secure the contract and Taxpayers profit factor would also be deducted from the tax base pursuant to A.R.S. 42-5075(B)(13) or any other provision of law?

### RULING:

Based on the information provided in your request, the Department rules as follows:

A contract for installation of solar collection on a new building project would be considered a contract subject to transaction privilege tax under the prime contracting classification. A contract for installation of solar collection on an existing facility will be considered an

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“alteration” contract subject to transaction privilege tax under the retail classification unless otherwise exempted by statute. To qualify as an alteration for a commercial property contract amount is \$750,000 or less; the scope of work directly relates to 40% or less of the existing square footage; and the scope of work includes an expansion of existing square footage that is 10% or less of pre-existing square footage. If these thresholds are exceeded, then the contract is a modification contract subject to TPT under the prime contracting classification. This analysis is done to the contract as a whole prior to any deductions being considered.

If the contract is a modification contract, gross proceeds of sales or gross income derived in connection with the components, main posts to elevate the solar panels, preparation of the foundation may be deducted under § 42-5075(B)(13) as a solar energy device because said items constitute “a system or series of mechanisms designed primarily . . . to produce electrical power. . . by means of collecting and transferring solar generated energy into such uses either by active or passive means . . .” A solar device is defined as a system or series of mechanisms designed primarily to provide heating, cooling, electrical or mechanical power, to provide solar daylighting or to provide any combination of the foregoing by means of collecting and transferring solar generated energy into such uses either by active or passive means. To be clear, the items listed by themselves are not solar devices – they are only solar devices if they are used as component parts of a solar device. Once the items form part of a solar device as that term is defined, they may be purchased free of TPT. A solar contractor may only deduct income derived from solar contracting activity if they register with the Department using Form 6015.

The repair of areas destroyed by the construction will likely have no gross receipts as they are a condition in your contract. The fencing to protect the panels would be subject to transaction privilege tax under the prime contracting classification as it is not a system designed to produce electrical power. The tax base for the prime contracting classification is sixty-five percent of a prime contractor's gross receipts derived from the business. Here, the fencing would be subject to TPT and any gross receipts derived from the erection of the fence would be subject to TPT.

If, however, the contract qualifies as an alteration, it would be subject to TPT at the retail level. A.R.S. § 42-5061(M) provides a deduction to retailers from the tax base for the sale of solar energy devices. As a prerequisite to be able to deduct the sale of solar energy devices from its tax base, the retailer must register with the Department as a solar retailer. No calculation would be required as to costs for the erection of the fence as it would not be subject to TPT under the prime contracting classification.

### **FACTS ASSERTED BY COMPANY:**

Taxpayers revenue will be attributable to contracts awarded for the provision and installation in Arizona of systems made up of interconnected solar energy devices designed to produce electrical power. The contracts are written and executed solely for the erection

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of such solar energy systems. All of the work under such contracts will be strictly limited to the clearing and other preparation of the site, the creation of the requisite foundation, the erection of the support system, the placement of the solar panels, the wiring and other interconnection of the solar panels via combiners, the installation of inverters to convert the current from DC to AC, and, when necessary, the erection of fences around the converter for safety purposes. Projects will not be performed by Taxpayer directly for the property owner, but rather third party entrepreneurs that will lease the space where solar devices are to be situated from the property owner, and then sell the energy produced by the solar collector system to the property owner.

The solar projects conclude with the repairing of any landscaping impaired during the course of the project, whether in the form of patching asphalt or concrete that has been cut to lay wire or pour foundations, or replacing sod destroyed during the various activities. All activities under the solar contracts to be undertaken by Taxpayer are directly related to the installation of the solar energy devices, and would not be undertaken but for the improvement of the property with the solar energy devices.

The placement of solar panels has to accommodate the available space. That might be building roofs, veranda roofs, open spaces where elevated structures can be erected or parking lots with or without existing covered parking. When new support frames will be erected where people will be congregating, the structures have to be high enough so that people will not be injured by the solar device components, which often have sharp edges. Conversely, elevating the equipment reduces the likelihood that the expensive and delicate equipment will be injured or tampered with by the public, and provides the panels with maximum exposure to sunrays. Furthermore, placing the panels on elevated structures designed for that purpose as opposed to existing roofs is more economical because reinforcing existing roofs to support additional weight of solar collector panels can be very expensive. Placing panels on roof also is not favored because it can interfere with building maintenance and firefighting.

If the panels are to be mounted on an existing veranda or roof, the solar panels may be placed directly on the raised surface, with no supporting substructure being required. On the other hand, if the solar panels are to be installed, for example, over a designated smoking area or a parking lot, the elevated structure could be as much as 16 feet over the finished grade. That might entail, for example, 24 foot long ½ inch thick steel I-beams to support the weight, 8 feet of which is subsurface to serve as the foundation. For purposes of this ruling request, it can be assumed the primary purpose of the structure is for the mounting of the solar panels for the production of electrical energy, to be consumed at the site, a configuration known in the industry as distributed generation (“DG”). Indeed as the solar collection system owner is interested only in receiving a favorable return on its capital investment from the sale of the electricity generated, it would not build the support structure “but for” its role in the production of solar energy. The solar collection system owner has no interest in spending additional funds to create any collateral benefits, such as the provision of shade. According to the contract, 8.2(b), “Construction Manager shall not conduct its

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operations and shall require all Subcontractors to conduct their operations so as to not cause damage to existing structures, including, but not limited to, adjacent property, Site Host facilities, any Utility equipment or facilities adjacent to the Site, roadways, or the Work.”

### DISCUSSION & LEGAL ANALYSIS:

Arizona imposes a transaction privilege tax (“TPT”) on the privilege of conducting business in the State of Arizona. The authority to levy TPT is found in Arizona Revised Statutes (A.R.S.) § 42-5008. The tax is levied on the seller, rather than the purchaser.

A.R.S. § 42-5061 imposes TPT under the retail classification. The retail classification is comprised of the business of selling tangible personal property at retail. The tax base for the retail classification is the gross proceeds of sales or gross income derived from the business. All sales of tangible personal property are subject to the transaction privilege tax under the retail classification unless specifically exempted or excluded by statute.

A.R.S. § 42-5061(M) provides a deduction to retailers from the tax base for the sale of solar energy devices. As a prerequisite to be able to deduct the sale of solar energy devices from its tax base, the retailer must register with the Department as a solar retailer.

A.R.S. § 42-5075 imposes TPT on “the business of prime contracting.” Fundamentally, prime contracting TPT can be understood as a tax on service activities. The tax base for the prime contracting classification is sixty-five percent of a prime contractor's gross receipts derived from the business. See A.R.S. § 42-5075(B). The tax base for TPT generally includes gross sales without any deductions for any business expense. Any deductions, exemptions, or exclusions from TPT must be specifically provided for in statute and they are unique to each classification. A contractor is not required to obtain (or renew) a prime contracting TPT license if its business activities are limited to contracts for the maintenance, repair, replacement, or alteration (“MRRA activities”) of an existing property with either: (a) the owners of real property or (b) the owners of the improvements to real property.

Modification no longer includes, maintenance, repair, replacement or alteration (“MRRA”). A.R.S. § 42-5075(O). Materials purchased by a contractor for use in maintenance, repair, replacement, or alteration activities will generally be subject to retail TPT at the time of purchase, unless such purchases are otherwise exempt from retail TPT. A contractor is not required to obtain a prime contracting TPT license if its business activities are limited to contracts for the maintenance, repair, replacement, or alteration of existing property with either: (a) the owners of real property or (b) the owners of the improvements of real property. A.R.S. § 42-5075(O). If a contractor performs modification contracts in addition to maintenance, repair, replacement, and alteration contracts, the contractor is subject to

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prime contracting TPT on its gross receipts from the modification contracts and is required to obtain a TPT license.

“Alteration” is an activity or action that causes a direct physical change to existing property. For purposes of this definition the following apply:

1. Residential property: If the contract price for the work is 25% or less of the property’s full cash value for property tax purposes (as stated on the County Assessor’s website or on the Notice of Value issued by the County Assessor), the contract falls within the meaning of an alteration under A.R.S. §42-5075(O).
2. Commercial property: If **all** of the following thresholds are satisfied, the contract is an alteration under A.R.S. §42-5075(O).
  - a. Contract amount is \$750,000 or less.
  - b. Scope of work directly relates to 40% or less of the existing square footage.
  - c. Scope of work includes an expansion of existing square footage that is 10% or less of pre-existing square footage.

If a project qualifies as an alteration under A.R.S. § 42-5075(O) at the time the contract is bid or entered into, subsequent increases to the contract amount/scope will not disqualify it as an alteration so long as none of the above thresholds is exceeded by more than 25% at completion.

Taxpayer must first determine if the contract is a modification or MRRA contract. Systems erected on existing facilities will be considered an “alteration” as it is a direct change to existing property. If the contract amount for a commercial property is over \$750,000, then it would be considered a modification contract subject to transaction privilege tax under the prime contracting classification.

A.R.S. § 42-5075(B)(13) provides an exemption for taxable periods beginning from and after December 31, 1996 and ending before January 1, 2017, for the gross proceeds of sales or gross income derived from a contract to provide and install a solar energy device. The solar contractor must register with the Department as a solar contractor to avail itself of this exemption.

A.R.S. § 42-5001(16) provides the following definition for “solar energy device:”

Solar energy device" means a system or series of mechanisms designed primarily to provide heating, to provide cooling, to produce electrical power, to produce mechanical power, to provide solar daylighting or to provide any

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combination of the foregoing by means of collecting and transferring solar generated energy into such uses either by active or passive means including wind generator systems that produce electricity. Solar energy systems may also have the capability of storing solar energy for future use. Passive systems shall clearly be designed as a solar energy device, such as a trombe wall, and not merely as a part of a normal structure, such as a window.

The terms "system or series of mechanisms," "produce electrical power," and "collecting and transferring" used in A.R.S. § 42-5001(15) are not defined in statute. Broadly, courts construe a tax statute "as a whole, and consider its context, language, subject matter, historical background, effects and consequences, and its spirit and purpose."<sup>1</sup> As a more specific general rule of construction, courts will consult an established and widely used dictionary to determine the common and ordinary meanings of terms that lack statutory definitions.<sup>2</sup> The analysis is further guided by another general rule of construction, which is that tax exemptions should be strictly construed, as they violate the policy that all taxpayers should share the common burden of taxation.<sup>3</sup>

### "System or series of mechanisms" as used in A.R.S. § 42-5001(15)

In looking at the phrase "system or series of mechanisms," the noun "system" means:

**I. An organized or connected group of objects.**

**1. a.** A set or assemblage of things connected, associated, or interdependent, so as to form a complex unity; a whole composed of parts in orderly arrangement according to some scheme or plan; rarely applied to a simple or small assemblage of things (nearly = 'group' or 'set').<sup>4</sup>

\* \* \*

The noun "series" means:

**I. General senses.**

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<sup>1</sup> *State ex rel. Ariz. Dep't of Revenue v. Phoenix Lodge No. 708*, Loyal Order of Moose, 187 Ariz. 242, 247, 928 P.2d 666, 671 (Ct. App. 1996).

<sup>2</sup> See, e.g., *Rigel Corp. v. State*, 225 Ariz. 65, 69, 234 P.3d 633, 637 (App. 2010) (court may consider "definitions of respected dictionaries" for words and phrases left undefined by the legislature); *United Dairymen of Ariz. v. Rawlings*, 217 Ariz. 592, 596, 177 P.3d 334, 338 (App. 2008).

<sup>3</sup> See, e.g., *Excell Agent Servs., L.L.C. v. Ariz. Dep't of Revenue*, 221 Ariz. 56, 57, 209 P.3d 1052, 1053 (App. 2010).

<sup>4</sup> "System, n." OED Online (2d ed. 1989).

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1. A number or set *of* material things of one kind ranged in a line, either contiguously or at more or less regular intervals; a range or continued spatial succession of similar objects; in early use applied to a row of building.<sup>5</sup>

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The noun "mechanism" means:

I. The structure or operation of a machine or other complex system; a theory or approach relating to this.

1. a. The structure of, or the relationship of the parts in, a machine, or in a construction or process comparable to a machine. (In early use chiefly with reference to natural systems.) Now *rare*.

\* \* \*

b. More generally: the interconnection of parts in any complex process, pattern, or arrangement. *Obs.*<sup>6</sup>

\* \* \*

### "Produce electrical power" as used in A.R.S. § 42-5001(15)

In looking at the phrase "produce electrical power," the verb "produce" means:

\* \* \*

3. To bring into being or existence.

a. *trans. gen.* To bring (a thing) into existence from its raw materials or elements, or as the result of a process; to give rise to, bring about, effect, cause, make (an action, condition, etc.).<sup>7</sup>

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### "Collecting and transferring" as used in A.R.S. § 42-5001(15)

In looking at the phrase "collecting and transferring," the verb "collect" means:

1. a. *trans.* To gather together into one place or group; to gather, get together.<sup>8</sup>

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5 "Series, n." OED Online (2d ed. 1989).

6 "Mechanism, n." OED Online (2d ed. 1989).

7 "Produce, v." OED Online (2d ed. 1989).

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The verb "transfer" means:

**1. a. *trans.*** To convey or take from one place, person, etc. to another; to transmit, transport; to give or hand over from one to another.<sup>9</sup>

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The portion of gross proceeds or income attributable to the portion of actual costs directly expended in providing architectural or engineering services is deducted from gross proceeds or gross income before computing the tax base. A.R.S. § 42-5075(B), (J). Actual costs directly expended in providing architectural or engineering services are referred to as "qualified direct costs" in this ruling.

The portion of actual costs not directly expended for architectural or engineering services is not a qualified direct cost under A.R.S. § 42-5075(K). Therefore, gross proceeds or income attributable to expended indirect architectural costs, indirect engineering costs, or construction costs do not qualify for the exemption provided by A.R.S. § 42-5075(K). The exemption under A.R.S. § 42-5075(K) is reported in a manner consistent with the reporting of the tax. A.A.C. R15-5-2211(B). Taxpayers claiming the exemption under A.R.S. § 42-5075(J) must retain adequate documentation to support the exemption from the tax base.

Since the tax base for the prime contracting classification is sixty-five percent of a prime contractor's gross receipts derived from the business, gross receipts derived from any portion of the contract will be subject to tax. See A.R.S. § 42-5075(B). Even though the contract presented will mainly be deductible under A.R.S. 42-5075(B)(13), the portions that are subject to tax must be taxed on their gross receipts.

**This response is a taxpayer information ruling (TIR) and the determination herein is based solely on the facts provided in your request dated November 30, 2015. 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 information 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.**

**If the Department is provided with required taxpayer identifying information and taxpayer representative authorization before the proposed publication date (for a published TIR) or date specified by the Department (for an unpublished TIR), the TIR**

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8 "Collect, v." OED Online (2d ed. 1989).

9 "Transfer, v." OED Online (2d ed. 1989).



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**will be binding on the Department with respect to the taxpayer that requested the ruling. In addition, the ruling will apply only to transactions that occur or tax liabilities that accrue from and after the date the taxpayer receives the ruling. The ruling may not be relied upon, cited, or introduced into evidence in any proceeding by a taxpayer other than the taxpayer who has received the taxpayer information ruling. If the required information is not provided by the specified date, the taxpayer information ruling is non-binding for the purpose of abating interest, penalty or tax.**

Lrulings/16-009-D