
Arizona Transaction Privilege Tax

*By James M. Susa**

James M. Susa describes the both the history and current application of the Arizona Transaction Privilege Tax.

Introduction

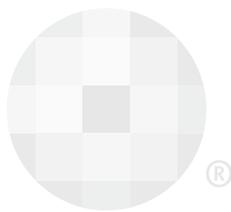
The purpose of this article is to give an overview of the Arizona Transaction Privilege Tax (TPT). It includes general information about the history of the TPT, the structure of the TPT and some nuances of the TPT unique to Arizona. Obviously in the space permitted it is not possible to present a comprehensive analysis of the 75 years of history of the TPT. This article just provides the basics.

History of the TPT

In the middle of the Great Depression, Arizona was looking for ways to provide government revenues. The property tax, long relied upon to fund the operations of state government, was declining significantly as property owners, faced with declining property values and lack of income from jobs, failed to pay property taxes. Bank foreclosures and tax deed sales of property in the early 1930's were prevalent. By comparison, the bank foreclosures and tax deed sales of 2009 pale in comparison to the dire situation in the 1930's.

At that time, Arizona looked to California for guidance on how to establish a new type of tax. California had adopted a sales tax upon retailers in 1933. Arizona, however, realized that imposing only a tax on retailers would create insufficient revenues to fund the government. Instead, Arizona chose to levy a tax upon several business activities, not just retailers. To accomplish this, Arizona chose a transaction based tax covering some services transactions (contracting, transportation) as well as the sale of tangible personal property.

In 1935, Arizona enacted the TPT, commonly called (though technically incorrect) the sales tax, to fund general education. The TPT was imposed at a very low



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rate of 1% on a few business types and with very few exemptions. By 1955, the tax rate had increased to 2%. Today the state TPT rate is 5.6% (cities and counties impose taxes as well, and the combined state, county and city taxes have rates as high as 10.725%).

Structure and Collection of the TPT

The TPT is an excise tax on the privilege of doing business in Arizona. The tax is not a sales tax. A sales tax is imposed upon the transaction of making a sale of tangible personal property and it is imposed upon the buyer of the property with the seller having an obligation to collect and remit the tax. California and Nevada have sales taxes. The TPT is imposed on the privilege of engaging in certain types of businesses that the State has chosen to subject to tax. The TPT is imposed directly upon the business and may, but does not have to be, passed on to the customer as either an included charge or a separately stated additional charge. The TPT is due from the seller whether passed on or not. To my knowledge, only New Mexico has a tax similar in structure to the TPT.

The Arizona Department of Revenue (“Department”) is responsible for the collection of Arizona TPT and for city privilege taxes from “program cities.” The largest cities in Arizona are not “program cities” and they maintain their own audit and collection divisions. The Department is divided into nine divisions and has over 600 full-time employee positions. The Department has three offices, Phoenix, Chandler and Tucson.

The Department collected, through returns or audit, \$5,600,595,181 in TPT in fiscal year 2007-08 (year ends June 30, 2008). The fiscal year 2008-09 figures are not yet available but will undoubtedly show significantly less in collections. The taxes were paid by 16 different business activity classifications. Not surprisingly the largest business classification subject to the TPT was 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. The amount of \$2,628,261,007, almost half of all TPT collected by the state and one quarter of all overall taxes collected by the state, was paid by those within the retail classification. The retail classification is likely going

to apply to sales of tangible personal property within the state unless the sale would more specifically fit into another classification, such as utilities or mining.

The other business classifications for the TPT, including fiscal year 2007-08 collections, are as follows:

- a. Transporting—The transporting classification is comprised of the business of transporting for hire persons, freight or property by motor vehicle, railroads or aircraft from one point to another point in the state. (\$2,417,925) This classification does not include those who transport product in interstate commerce.
- b. Utilities—The utilities classification is comprised of the business of producing and/or furnishing to consumers natural or artificial gas and water, and providing to retail electric customers ancillary services, electric distribution services, electric generation services, electric transmission services and other services related to providing electricity. (\$461,454,863) Common payers of this tax are the electrical and gas utilities located throughout the state.
- c. Telecommunications—The telecommunications classification is comprised of the business of providing intrastate telecommunications services. (\$183,289,498) This includes mostly the providers of monthly telephone service.
- d. Publication—The publication classification is comprised of the business of publishing newspapers, magazines or other periodicals and publications if published in-state. (\$6,125,071) This classification includes the revenues received by the local newspapers and magazines. Those created out-of-state are not subject to tax under this classification, but may be subject to the use tax if certain conditions apply.
- e. Job Printing—The job printing classification is comprised of the business of job printing, engraving, embossing and copying. (\$19,528,119)
- f. Pipeline—The pipeline classification is comprised of the business of operating pipelines for transporting oil, natural gas or artificial gas through pipes or conduits from one point to another point in the state. The pipeline classification does not include sales of natural gas or liquefied petroleum gas used to propel a motor vehicle. (\$799,649 combined amount with Private Car Line) While

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Arizona has a number of pipelines transporting gasoline and natural gas through the state, most originate outside the state meaning they are not subject to tax under this provision.

- g. Private Car Line—The private car line classification is comprised of the business of operating a private car company, as defined in Ariz. Rev. Stat. § 42-14301, from one point to another point in the state. (\$799,649 combined amount with Pipeline)
- h. Commercial Lease—The commercial lease classification is comprised of the business of leasing for a consideration the use or occupancy of real property. (-\$16,698) The negative amount must mean that a refund for prior year's taxes was paid. The existing state tax rate on this classification is 0%, though the classification remains on the books.
- i. Transient Lodging—The transient lodging classification is comprised of the business of operating, for occupancy by transients, a hotel or motel, including an inn, tourist home or house, dude ranch, resort, campground, studio or bachelor hotel, lodging house, rooming house, apartment house, dormitory, public or private club, mobile home or house trailer at a fixed location or other similar structure, and also including a space, lot or slab which is occupied or intended or designed for occupancy by transients in a mobile home or house trailer furnished by them for such occupancy. (\$132,163,437) The various high end resorts and spas located in the state make up the bulk of this classification.
- j. Personal Property—The personal property rental classification is comprised of the business of leasing or renting tangible personal property for a consideration. (\$199,569,370)
- k. Mining—The mining classification is comprised of the business of mining, quarrying or producing for sale, profit or commercial use any nonmetallic mineral product. (\$6,761,355) Copper mining is not within this classification. Copper mining is subject to the severance tax, which is imposed at a much lower rate and on a much smaller tax base. Importantly, the mining classification applies even if the mined product is not sold or is sold outside of Arizona. That is a fairly unique aspect of any transactions based tax.
- l. Amusement—The amusement classification is comprised of the business of operating or conducting theaters, movies, operas, shows of any type or nature, exhibitions, concerts, carnivals, circuses, amusement parks, menageries, fairs, races, contests, games, billiard or pool parlors, bowling alleys, public dances, dance halls, boxing and wrestling matches, skating rinks, tennis courts, except as provided in subsection B of this section, video games, pinball machines, sports events or any other business charging admission or user fees for exhibition, amusement or entertainment, including the operation or sponsorship of events by a tourism and sports authority under Arizona Rev. title 5, chapter 8. (\$57,246,984)
- m. Restaurant—The restaurant classification is comprised of the business of operating restaurants, dining cars, dining rooms, lunchrooms, lunch stands, soda fountains, catering services or similar establishments where articles of food or drink are sold for consumption on or off the premises. (\$482,664,165)
- n. Prime Contracting—The prime contracting classification is comprised of the business of prime contracting and dealership of manufactured buildings. (\$1,006,520,212) This classification leads to the most confusion among taxpayers, especially those from outside Arizona who are accustomed to paying sales tax on their construction materials and no tax on their gross receipts from construction building. Most audits performed by the Department are on contractors and the Department usually prevails in those audits.
- o. Owner Builder Sales—The owner builder sales classification, comprised of persons who sell real property as improved at any time on or before the expiration of twenty-four months after the improvement is substantially completed, meaning suitable for the use or occupancy intended, shall be subject to tax under this classification for the purpose of taxing the sale of those improvements incorporated within that twenty-four month period. (\$0) This classification still has a tax rate, but with a law change many years ago, there are few if any who actually qualify for taxation under this category.

Of the 16 classifications, 81.7% of all TPT collected in fiscal year 2007 came from the retail, prime contracting, utilities and restaurant classifications. Due to this concentration of taxes collected from just four business classifications, the TPT is highly cyclical. During past recessions in Arizona, the pattern of tax collection is the same. Generally, when large declines in retail and restaurant spending occur due to lower discretionary household income, large declines also occur in contracting and utilities due to reduced demand for new housing.

The TPT tax base starts with the “gross receipts,” “gross income” or “gross proceeds of sales” from the business activity. Those terms are broadly defined to capture as large of an amount as possible within the tax net. For instance, gross receipts means “the total amount of the sale, lease or rental price, as the case may be, of the retail sales of retailers” Similar sweeping definitions of “gross income” and “gross proceeds of sales” exist in the statutes.

The TPT structure is to broadly define what is initially subject to the tax, but then to remove by exemption those things that public policy dictates should not be subjected to the tax. In theory, exemptions from the tax are to be the exception, not the rule. Further, a court’s interpretation of an exemption statute is to be in favor of payment of the tax and against the exemption. Exemptions must be clearly written to apply to the facts and circumstances of the proposed exempt transaction or they do not apply.

Nevertheless, there has been a proliferation of exemptions within the TPT. For example, in the retail classification there were 13 exemptions within paragraph A in 1990. Thus, in the 55 year span from 1935 to 1990, public policy considerations were sufficient to have 13 specific exemptions within that paragraph in the retail classification. By 2008, there were 55 exemptions within the same paragraph A. This has led to a number of questions as to whether all 55 exemptions are truly meritorious. That question is left to the politicians.

Practical Aspect of TPT Compliance

Each business subject to the TPT must obtain a license from the Department. Once licensed, the business must prepare returns either monthly, quarterly or annually, depending on the volume of activity to be reported, and file those returns with the Department. Returns are due on the 20th of the month following the month in which the activity took place giving rise to the tax due. Returns are delinquent if not:

1. postmarked by the 25th day of the month, if mailed;
2. received by the Department on or before the business day preceding the last business day of the month, if filed by mail;
3. received by the Department on or before the last business day of the month, if filed electronically; or

4. for all others, received by the Department on or before the business day preceding the last business day of the month.

A business collecting the TPT is required to remit all tax that is collected. The tax owed becomes a debt to the state and the state may sue the business to recover the tax as if it were any other creditor. Additionally, if the tax is collected from the consumer as “an additional charge made to cover the tax” and the collected tax is not remitted to the Department, an officer or director of the business that collected the tax is personally liable for payment of the tax. Arizona’s courts have adopted the same standard as the “responsible person” for federal withholding taxes to determine who is individually liable for payment of the collected tax. This concept of individual liability for collected yet not remitted TPT is fairly new in Arizona and the boundaries of who is liable, how much they are liable for, when are they liable and whether this liability can be discharged in bankruptcy are all being fleshed out now.

Audits, Protests and Dispute Resolution

The Department audits most large business entities within Arizona on a recurring three year cycle. The statute of limitations for assessing additional TPT is four years. The Department has 50 TPT auditors spread among the three Department offices. The Department issues a tentative assessment at the conclusion of the field work and requests the business owner to review for obvious errors. If no response is received, or if a response is received that does not influence the auditor to change the tentative assessment, the Department will issue a proposed assessment via certified mail. If the auditor agrees with the business owner’s comments, another tentative assessment is issued.

The proposed assessment must be protested in writing to the Department within 45 days of receiving the proposed assessment. The protest must list what portion of the proposed assessment is being protested. Failure to protest within the 45 days leads to the proposed assessment becoming a final assessment that is immediately due and payable. In theory, any items not protested should be paid at the time of protest. Few people ever do this, though the Department does have the ability to then bill the business for the unprotected balance. If the assessment becomes final, the Department is prohibited to reopen the audit period. Thus, there may be times when a business will choose to not protest a

proposed assessment even if it believes the basis for the proposed assessment is questionable.

After receiving the protest, the Department will schedule an informal conference with the Department auditor and their supervisor if requested by the business. The informal conference provides a very good opportunity to get a plain explanation of assessment issues and reasons therefore. The informal conference is usually scheduled about 6 weeks after the protest is filed. Often the result of the informal conference is an agreement to proceed in a certain manner (litigation, settlement, offer-in-compromise) making the resolution of the protest a little more focused.

If there is no agreement at the informal conference, the protest is then referred to the Arizona Office of Administrative Hearings (OAH) to schedule a formal hearing before an Administrative Law Judge. OAH is a separate agency from the Department and numerous state agencies have contested cases heard by OAH. Unfortunately, the time between the holding of the informal conference and a protest being set for hearing at OAH is about 18 months due to the limited resources available to the Department and OAH for handling protests, though the Department and OAH have reduced that time considerably in the last few years.

Hearings at OAH are recorded, witnesses are sworn, and documentary and testimonial evidence is offered and admitted. The Department is represented by in-house attorney. The business protesting the proposed assessment has both the burden of persuasion as to any legal issue and of proof as to any factual assertion. Legal briefs may be filed if allowed by the Administrative Law Judge. All matters are taken under advisement at the conclusion of the hearing and a written decision setting forth findings of fact and conclusions of law is issued about four weeks after hearing occurs or after the last legal brief filed if the briefing schedule occurs.

If the business loses in the OAH hearing, it may appeal that decision to the Department's Director, the State Board of Tax Appeals or the Arizona Tax Court. If the Department loses at the OAH hearing,

it may only appeal that decision to the Department's Director. If the Department does not appeal the OAH decision, the case is final and the proposed assessment is invalid. If the Director rules against the Department on appeal, the case is final and the proposed assessment is invalid.

If there is an appeal to the Department's Director, the parties only present briefs on the factual and legal issues presented at the OAH level. No hearing is held. The Director will then issue a written decision that either affirms, reverses or modifies the OAH decision. A Director's decision adverse to the business may be appealed by the business to either the State Board of Tax Appeals or the Arizona Tax Court.

An appeal to the State Board of Tax Appeals is treated as a new hearing with the Board placing no reliance or weight on the prior proceedings. The Board requires both parties to file memorandums of fact and law. The Department is represented before the Board by the Attorney General's Office. The Board is comprised of three individuals. The Board allows a one hour hearing and a written decision is issued about three months after the hearing.

Either party can appeal a State Board decision to the Arizona Tax Court. If that occurs, the case is treated like any other civil lawsuit. The proceedings in the Tax Court are not on the record from the administrative tribunals below and all facts must be proved just like in any other civil lawsuit with discovery, rules of civil procedure and evidence, motions etc. There is one Tax Court judge in Arizona and that judge hears all cases assigned to the Tax Court.

Conclusion

The TPT is unlike most other states' sales tax and particular attention should be paid to the words of the statutes imposing the tax, rules promulgated by the Department and reported cases, judicial and administrative.

* The views expressed herein are those of the author and may or may not be those of the Arizona State Board of Tax Appeals, of which the author is a member.

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