



CITY OF TUCSON

A GUIDE TO UNDERSTANDING BUSINESS TAXES AND LICENSES

CONSTRUCTION CONTRACTING BROCHURE: PRIME CONTRACTORS AND SUBCONTRACTORS

This brochure is intended to help prime contractors and subcontractors understand the business privilege (sales) tax laws that apply to their business. This information is based on the City of Tucson Business Privilege Tax Code in effect on January 1, 2015. In case of inconsistency or omission, the Tucson Tax Code will prevail.

Effective January 1, 2015, non-construction, or service contractors, are exempted from prime contracting on both the state and city levels. Contractors who only enter into contracts with owners of real property to maintain, repair, replace, or alter their property will be subject to tax at the point of purchase on the building materials used in those projects. All other contracting activity remains taxable under the current code.

WHO IS A CONSTRUCTION CONTRACTOR?

A contractor is any person or organization that undertakes to modify any building, highway, road, railroad, excavation, manufactured building, or other structure, project, development or improvement or do any such project and including scaffolding or other structure or works in connection with such a project. Contractors can perform the work personally or through others, and includes specialty contractors, *prime contractors*, *subcontractors*, general contractors, speculative builders and owner-builders.

Both speculative builders and owner-builders may improve real property that they own; however, speculative builders do so in anticipation of selling the improved real property at a later date. Please be advised that there are additional tax considerations when a speculative builder sells improved property, which is not addressed in this brochure. (See the Owner Builder & Speculative Builder brochure)

WHAT IS MODIFICATION?

“Modification” means construction, grading and leveling ground, wreckage and demolition activities to the extent that they cannot otherwise be characterized as Maintenance, Repair, Replacement & Alteration activities.

Modification does not include any wreckage or demolition of existing property or any other activity that is a necessary component of a maintenance, repair, or replacement project; or any mobilization or demobilization related to a MRRA project, such as erection or removal of temporary facilities to be used by people working on the project.

WHAT ARE MRRA CONTRACTS?

MRRA is the acronym for Maintenance, Repair, Replacement & Alteration.

“Maintenance” is the upkeep of property or equipment. (Examples: Changing filters, lawn mowing, and refinishing floors)

“Repair” is an activity that returns real property to a usable state from a partial or total state of inoperability or nonfunctionality. (Examples: fixing a broken pipe or replacing loose shingles on a roof.)

“Replacement” is the removal of one component or system of existing property or tangible personal property with a new one that provides the same or upgraded functionality. (Example: Replacing an HVAC system with a new, more efficient one.)

“Alteration” is an activity or action that causes a direct physical change to existing property. There is a multi-prong test that must be applied to each project to determine if the project is an alteration and therefore tax exempt or if the job is considered modification and therefore taxable contracting.

1. Alteration is only in MRRA now. All tax is based on the purchase price of materials.
2. There are two types of alteration: residential and non-residential.
3. There are separate thresholds for the two types of alteration. The thresholds were established in the statute to distinguish between “Alteration” and “Prime Contracting”.
 - a. Residential property. The value of the original contract must be no more than 25% of the current Full Cash Value per the County Assessor website. If the Full Cash Value changes between the bid and the contract, the higher value is used. For example, if the Full Cash Value is \$400,000, then the contract’s threshold is \$100,000.
 - b. Non-residential properties (Commercial or other properties). To qualify as a non-residential alteration **all three** requirements must be met.
 - 1) Price of the job is less than or equal to \$750,000, (This amount is based on the ROC requirement for small commercial builders.), **and**
 - 2) Project alters 40% or less of the original square footage of the structure, **and**
 - 3) No more than an additional 10% of the original square footage is added to the existing structure.

IS A CONSTRUCTION CONTRACTOR RESPONSIBLE FOR THE TAX?

All construction contractors are responsible for the business privilege (sales) taxes due on 65% of the total income received for the job. If a construction contractor hires a subcontractor (“sub”) to furnish and install materials, the construction contractor cannot deduct the amount paid to the subcontractor from their total income.

WHAT IS A SUBCONTRACTOR?

A subcontractor is a construction contractor working for another construction contractor, a speculative builder, a seller of new manufactured buildings, or another subcontractor.

To be exempt from tax a subcontractor must obtain a written statement from the responsible party (usually the prime) stating 1) who is liable for the sales tax and 2) the responsible party’s tax license numbers. The City of Tucson accepts the State of Arizona Form 5005- Prime Contractor’s Certificate, if properly completed by the responsible party, as sufficient proof of a subcontractor’s release from sales tax liability. Subcontracting income is exempt from sales tax with this documentation. Documentation must be provided for each project.

WHAT ARE THE LICENSING REQUIREMENTS FOR A CONTRACTOR?

1. If the contractor only performs MRRA work, no subcontracting, and no new construction, then they should **cancel** their MTL license. **They will still need a city business license if they conduct business in the city.** They will always pay tax to their vendors or suppliers for materials.
2. If the contractor only conducts MRRA work, no subcontracting, and no new construction but does make retail sales of tangible personal property, then they need to **keep both** their MTL and Business licenses. They can pay tax on materials to be used in MRRA projects to their vendors and purchase the materials they will be reselling at retail tax exempt.
3. If the contractor always conducts new construction, or subcontracting work, then they will need to **keep both** their MTL and Business licenses. They will purchase their materials tax exempt and if they are prime contractors pay the City tax on 65% of the total gross income for jobs performed in the city. If they are subcontractors, they should secure a Form 5005 from the prime contractor and deduct the sub-contracting income on their tax return.
4. If the contractor does MRRA type work and new construction, taxable alteration work, or subcontracting work on new construction, then they should **keep** their license. This will allow them to purchase all of their materials tax exempt but they have a choice if the materials are for an MRRA job.
 - a. If they purchase the materials tax exempt and do an MRRA job, then they will need to pay the equivalent “retail” tax on the cost of the materials to the jurisdiction(s) where the job was done.

- b. If they choose to pay tax on the materials for an MRRA job to the supplier, then they do not need to pay tax to the jurisdictions.
 - c. They should always purchase materials that will be used in a new construction job, taxable alteration job, or subcontracting job tax exempt from their suppliers using the ADOR form 5000, Transaction Privilege Tax Exemption Certificate.
 - d. If a contractor has paid the equivalent “retail” tax to the city on materials for an MRRA job and it changes to a taxable modification job, then the contractor can take a credit for the taxes paid to the City. **They cannot take the credit if they paid the tax to their supplier.**
5. Contractors having taxable inventory need to **keep** their license active until all of the use tax or retail tax has been paid on the inventory. See Handling of Inventory below as either could apply.
 6. If the contractor purchases their materials from out-of-state vendors and they kept their MTL, then they will either pay the contracting tax or retail tax on those materials when installed depending on the type of job. If the contractor only performs MRRA work and could opt to cancel their MTL License but routinely purchase their materials from out-of-state vendors, these Contractors will need to keep the MTL and report “retail” tax on the purchase price of those materials. The retail tax will be paid to the jurisdiction where the business is located.
 7. If a contractor performs MRRA work for qualified hospitals where the purchase of the materials is exempt under retail and prime contracting, then the contracting business will need to keep their license to purchase those materials tax exempt.

HOW DOES SALES TAX APPLY TO A CONTRACTOR?

The City of Tucson Business Privilege Tax Code states that tax is due on the gross income, *less allowable exemptions and deductions*, of “every construction contractor engaging or continuing in the business activity of construction contracting within the City.”

Gross income includes all of the gross receipts received from customers. It should include both taxable and nontaxable income. Tax is due either on a cash basis or accrual basis, not at the completion of a contract.

WHAT ARE ALLOWABLE DEDUCTIONS OR EXEMPTIONS FROM GROSS INCOME AVAILABLE TO A CONTRACTOR?

Allowable deductions and exempt income include, but are not limited to:

- Charges related to the installation of groundwater measuring devices
- Income from remediation contracting work
- Out-of-city income
- Income from jobs located on Davis-Monthan Air Force Base
- Subcontracting income, when working for a licensed construction contractor
- Design and engineering fees, if separately stated
- Personal property installed for qualified health care organizations
- Income from the sale of income-producing capital equipment
- Income from the sale of solar energy devices through December 31, 2016.
- Development or impact fees included in contracts for payment to the state or city government to offset governmental costs of providing public infrastructure, public safety, and other public services to the development.
- Sales tax (separately stated on invoices and in the contractor’s records) charged and collected; or, if no tax was separately charged, *factored tax*
- The standard deduction of 35%, calculated after gross income has been reduced by all other exemptions and deductions

WHAT IS FACTORED TAX?

The sales tax for the City of Tucson is a business privilege tax on the seller. This means it is not necessary for the seller to separately state an amount for tax on their billings of goods or services. If an amount for tax is separately stated then that is the amount that must be deducted on the tax reports. Factored tax is the calculated amount of tax that is deducted on the tax reports when tax is not separately stated on billings.

For sales by contractors, the computation is a little more involved, as the total sales price includes the 35% standard deduction allowed to contractors. Therefore, instead of dividing the total sales price by 1 plus the current tax rate (1.081, in the example above), you must first reduce the tax rate by the 35% standard deduction.

Example:

Total sales price, including tax	\$2,350.00
Current tax rate	8.1% (.081)
(State of Arizona – 6.1%, City of Tucson - 2%)	
.081 x 65%	5.265% (.05265)
(8.1% less the 35% standard deduction)	

Computation:

\$2,350.00/1.05265 =	<u>\$2,232.46</u>	(total sales price less factored tax)
\$2,350.00 - \$2,232.46 =	<u>117.54</u>	(factored tax)

Check your calculation and compute the tax due the State of Arizona and the City of Tucson:

Total sales price, including tax	\$2,350.00 A
Less: factored tax (from above)-	<u>117.54 B</u>
Sales price w/o the factored tax	\$2,232.46 C (A - B)
Less: 35% (C x .35)	<u>- 781.36 D</u>
Taxable income	<u>\$1,451.10 E (C - D)</u>
Tax due State of AZ (E x 6.1%)	\$ 88.52
Tax due City of Tucson (E x 2%)	+ <u>29.02</u>
Total tax due (factored tax)	\$ <u>117.54</u>

FOR MORE INFORMATION ABOUT...

Taxes –Audit Section: City of Tucson – Tax Audit Section - (520) 791-4681
 255 W. Alameda - Second Floor,
 P.O. Box 27210, Tucson, Arizona, 85726-7210

Licenses –License Section: City of Tucson - License Section - (520) 791-4566
 255 W. Alameda - First Floor
 P.O. Box 27210, Tucson, Arizona, 85726-7210

Hearing impaired: TDD (520) 791-2639

Visit the City of Tucson Web Page at: <http://www.tucsonaz.gov>

To read more about the business privilege tax: <http://finance.tucsonaz.gov/finance/business-license-and-tax-information>.

The City of Tucson prepared this brochure. It does not provide comprehensive explanations of Tucson tax laws, rules, or regulations. Specific questions should be addressed to the City of Tucson Tax Audit Section. Rev. 04-15