

# CONSTRUCTION CONTRACTING

## YOU OWE TAX ON CONSTRUCTION CONTRACTING IF:

You are in the construction business in the city of Prescott. A contractor is considered to be in business in Prescott when the construction job is in Prescott. Contractors report the income from each job to the Arizona city in which the job is located, not to the city in which the contractor is based. A construction contractor who provides only labor is subject to the same provisions as one who provides both materials and labor

Since January 2015, not all contracting is taxable. Gross income derived from maintenance, repair, replacement or alteration ("MRRRA") on existing real property is not subject to tax.

## WHAT IS TAXABLE CONSTRUCTION CONTRACTING?

There are two types of treatments of construction contracting for taxation purposes:

**Type 1:** Contracting income is exempt but tax on materials is due at the place of purchase.

This type of tax treatment is for MRRRA construction activities that fall into the following definitions:

**Maintenance** – is the upkeep of property or equipment. Examples include HVAC system checkup, re-staining a wood deck.

**Repair** – is an activity that returns real property to a useable state from inoperability. Examples include fixing bathroom fixtures, fixing a door, fixing wires

**Replacement** – is the removal from service of one component or system of existing property and installation of new property that provides the same or upgraded design or functionality. Examples include any required removal and installation of a bathtub, bathroom fixtures, a tile roof, HVAC unit.

**Alteration** – is an activity that causes a direct physical change to existing property. Examples include building a kitchen island, taking out a wall, installing a new floor, expanding a deck, constructing a home addition.

If all of your construction work can completely be classified as MRRRA, you are not required to have a Transaction Privilege tax license or report to the City.

**Type 2:** Taxable on the contracting gross income but materials incorporated into the project are purchased tax exempt.

These taxable activities encompass "ground up" construction, grading and leveling ground, and wreckage or demolition activities to the extent they cannot be characterized as MRRRA activities. Examples include new construction of residential or commercial buildings, a contract with ADOT, a city or town involving surface or subsurface improvements to land.

## ARE THERE ANY THRESHOLDS?

Any job amount for "maintenance", "repair", or "replacement" activities qualify as exempt contracting.

For "alteration", however, certain thresholds must be met to qualify. If an alteration project exceeds these thresholds, the tax treatment is type number 2, with gross income becoming taxable. These are:

Residential Property: 25% or less of the Full Cash Value of the property.

Commercial Property: All of the following thresholds must be satisfied to be exempt: (1) the Alteration contract is for \$750,000 or less, and (2) the scope of work is 40% or less of the existing square footage, and (3) if the scope of work includes an expansion of square footage at no more than 10% of pre-existing footage.

Note that if a project at the time of the initial contract is MRRRA Alteration, it will remain MRRRA Alteration as long as subsequent cost overruns or change orders do not exceed 25% at completion.

## ARE SUBCONTRACTORS TAXED?

Subcontracting income is exempt from tax. To qualify for this exemption, the subcontractor must obtain an Arizona Department of Revenue's form 5005 from the prime contractor.

## ARE OWNER-BUILDERS TAXED?

Owners who are improving real property for themselves may or may not be the party liable for paying the tax on the construction.

A homeowner who is building his own principal residence would not normally be the liable party. Each of the contractors or suppliers who provide materials and/or services would be liable based on their income from the job.

A "speculative builder" who is building a home or other property for sale would be liable for tax based on the property's sales price. For more information regarding this tax, please refer to the brochure.

## GROSS INCOME

Contractors are taxable based on their gross income from the contracting business. Normally this will be either the total amount of the contract or the sales price of the property when it is sold. The income is taxable regardless of whether it includes both labor and materials or just labor.

Contractors may report on a progressive billing basis or on a cash receipt basis. Speculative builders report the total selling price at the time of close of escrow.

## DEDUCTIONS

The following are typical deductions subtracted from the gross income to arrive at the taxable income:

- Fair market value of land if included in gross income (speculative builders)\*
- Privilege tax collected separately or factored\*\*
- MRRRA contracting
- Out-of-City contracting
- Standard 35% labor deduction\*\*\*
- Exempt subcontracting
- Design and engineering fees
- Impact fees
- Contract to install a solar energy device

\*Speculative builders are allowed a land deduction at fair market value. In lieu of documented fair market value, a deduction of 20% of the gross selling price is allowed.

## EXEMPTIONS CERTIFICATES

Form 5000 – Use this form to provide to retailers for building materials incorporated into a taxable contracting job. This exemption does not apply to construction equipment and tools, any other tangible personal property which is not incorporated into the actual improvements being built, or materials purchased directly by an owner-builder.

Form 5005 – Use this form to provide to a subcontractors establishing liability for tax on the job.

Form 5009L – Use this form if you do not have a license but want to work for a general contractor on a new construction project. The general contractor will fill out the Form 5009L and list all subcontractors on the project. This form will be sent to the State for approval. Once approved, this form can be used to purchase materials without paying retail tax at the time of purchase. It will be the responsibility of the general contractor to pay the tax on the job.

Form 5009M – Use this form if it is a MRRA project involving exempt contracting to purchase of building materials that are statutorily exempt from tax. Examples include work for hospitals, projects for Indian Tribes, or projects where the general intends to pay retail tax on all materials incorporated.

### FURTHER INFORMATION:

If you need more information on how to report prime contracting income or MRRA see Arizona Transaction Privilege Tax Notice 18-1, available here: [https://azdor.gov/sites/default/files/PUBLICATI ON\\_2018\\_tpn-18-1.pdf](https://azdor.gov/sites/default/files/PUBLICATI ON_2018_tpn-18-1.pdf)

You can apply, report, and pay taxes online at [www.aztaxes.gov](http://www.aztaxes.gov).



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\*\*If you have not charged your customer privilege tax, you may “factor” your tax. This means that the total contract price includes tax and you can compute the amount of tax and deduct it. Formulas for factoring tax are included below.

\*\*\*A standard 35% deduction is allowed for all income taxable as contracting. This is in lieu of an actual labor deduction. This 35% should be computed after the land (if applicable) and privilege tax deductions have been taken.

### FACTORING PRIVILEGE TAX

A total Transaction Privilege (Sales) Tax rate of 8.35%, (6.35% State and County, 2.00% Prescott), is imposed on the gross income of any person engaging in Construction Contracting. If tax has been neither separately charged nor separately collected, factoring of tax is allowed in computing taxable income.

When reporting income, the total sales price should be reported as the gross. Deductions, if applicable, can be taken in the following areas and in the following order.

1. Subcontracting
2. Out-of-city contracting
3. Fair market value of land if included in gross (if not documented, 20% of sales price)
4. MRRA contracting

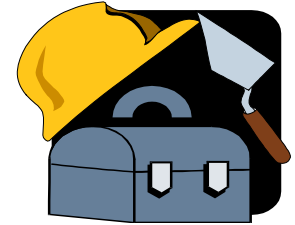
**Factored Tax.** The deduction for tax included in the contract price is computed by multiplying the total price less the deductions above by 0.05148088. This factor is for contracting activity subject to the 5.6% State tax, the 0.75% Yavapai County tax as well as the 2.00% City of Prescott tax. (Factors will vary depending on city and county tax rate.)

#### For Example:

Sales Price (includes land)	\$100,000.00
Less:	
Land	20,000.00
Factored Tax	4,118.47
35% Contractor's Ded.	<u>26,558.54</u>
Taxable Amount	<u>\$49,322.99</u>

# PRESCOTT PRIVILEGE TAX

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This publication is for general information regarding Transaction Privilege (Sales) Tax on construction contracting. For complete details, refer to the City of Prescott Privilege & Use Tax Code, Arizona Revised Statutes, and related regulations. In the case of an inconsistency or omission in this publication, the language of the Tax Code will prevail. The transaction privilege tax is commonly referred to as a sales tax, however, under State of Arizona law, the tax is on the privilege of doing business in Prescott and is not a true sales tax.

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